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

INTRODUCTION

On January 12, 2001, the Treasury Department issued proposed modifications to the regulations governing practice before the Internal Revenue Service (the "Service"),[2] 31 CFR part 10, reprinted as Treasury Department Circular 230. The proposed modifications (the "Proposed Rules")[3] would both clarify and modify the general standards of practice before the Service and the standards for providing tax shelter advice. Before issuing the Proposed Rules, Treasury issued two notices announcing that Circular 230 would be revised and seeking comments on a variety of matters.[4] Responding to these requests, we submitted a report in July, 2000, commenting primarily on the standards of practice governing opinions issued in connection with corporate tax shelters (the "July 2000 Report").[5] This Report offers our comments on the Proposed Rules, and our suggestions regarding corresponding changes we believe should be made to the regulations under Sections 6662 and 6664 of the Internal Revenue Code of 1986 (the "Code").

To begin, we commend Treasury on the Proposed Rules. This is an important project well worth the resources and time devoted to it. We applaud your solicitation of comments prior to issuing the Proposed Rules and recognize that Treasury gave in-depth consideration to the comments it received. We believe the Proposed Rules update and improve existing Rules. In particular, as noted in our July 2000 Report, we believe adding standards for tax shelter opinions that are not used in marketing, as the Proposed Rules would, is an important step in the battle to combat the proliferation of abusive tax shelters.

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1 This Report was prepared by the Committee on Compliance, Practice and Procedure, Robert S. Fink and Arnold Y. Kapiloff, Co-Chairs. Its principal drafters were Arnold Y. Kapiloff and Diana L. Wollman, with helpful comments provided by Kimberly S. Blanchard, Samuel J. Dimon, Robert S. Fink, David P. Hariton, Robert A. Jacobs, Carolyn Joy Lee, William B. Randolph, Michael L. Schler, Andrew P. Solomon, and Lewis R. Steinberg.

2 REG-111835-99.

3 The term "Proposed Rules" in this Report refers to the proposed revised version of Circular 230 in its entirety, rather than just the specific additions and deletions being provided by the proposed modifications.

4 65 F. R. 30375 (May 2, 2000) and 64 F. R. 31994 (June 15, 1999).

5 New York State Bar Association Tax Section Report #978 (July 31, 2000), reprinted at 2000 TNT 150-31.

COMMENTS

Section 10.20. Information to be furnished.

RECOMMENDATION: Section 10.20(a)[6] should not require the practitioner to provide the Service with any information the practitioner or the client has regarding the identity of any person who may have possession or control of records or information the Service has requested. Section 10.20(a) should not require a practitioner to obtain records or information from a client in order to respond to a request issued by the Service to the practitioner.

Current Section 10.20(a) requires a practitioner to submit to the Service records or information that have been lawfully requested, unless the practitioner believes in good faith and on reasonable grounds the records or information are privileged. Proposed Section 10.20(a) would expand this delivery requirement by *also* requiring the practitioner, where the records and information are not in the possession or control of the practitioner or the practitioner's client, to provide the Service with "any information that the practitioner or the practitioner's client has regarding the identity of any person who may have possession or control of the requested records or information."

We have several concerns about this proposed addition. While we recognize the importance to the Service and the desirability of enabling the Service to obtain access to documents and information to properly enforce the revenue laws, we believe the potential problems raised by this proposed revision outweigh its potential benefits, particularly because the Service could obtain the same information using alternative less problematic methods.

To the extent the proposal requires a practitioner to provide "any information" the practitioner has regarding the identify of "any person who may have" the records or the information, the proposal is vague and overbroad and may place an unreasonable burden on a practitioner who attempts in good-faith to fully comply. It may be a major, or impossible, undertaking for a practitioner to determine who *may* have the requested records or information and to compile the information the practitioner has regarding the "identity" of those persons. This is particularly likely to be the case where the practitioner has had a lengthy relationship with the client or the requested records or information relate to a transaction (or other type of matter) that involved multiple parties or multiple assets. Proposed Section 10.20(a) provides no guidance as to what standard the practitioner is to use in determining who *may* have the records or information or how much and what type of information the practitioner must provide "regarding the identity" of each potential information possessor.

We are concerned that requiring a practitioner to turn over information regarding persons who "may" have the requested records or information may create a serious ethical and/or professional conflict for the practitioner. Turning over the information may conflict with ethical guidelines or violate disciplinary rules promulgated by other bodies governing professional conduct, such as the American Bar Association and applicable governing state bars. For example, Rule 1.6 of the ABA Model Rules of Professional Conduct provides that a lawyer

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[6] All Section references are to sections of Circular 230 and the Proposed Rules, unless otherwise indicated.

shall not reveal information relating to the representation of a client unless the client consents.[7] How is a tax practitioner to proceed when faced with an obligation under Circular 230 to turn over information and an obligation under the governing rules of professional responsibility in his or her state of admission to *not* turn over that information?

Perhaps even more importantly, confidentiality rules have been adopted by the ABA and state bars with an important goal in mind, and one that Circular 230 should promote, rather than hinder. Specifically, the rules obligating a lawyer to secrecy, whether or not the information is technically covered by the attorney-client privilege, are intended to encourage people to seek legal advice and to fully disclose all relevant facts to their legal advisors to enable clients to obtain complete advice enabling the client to make fully informed decisions. The obligation also aids the lawyer who cannot provide adequate advice without all relevant information. The non-disclosure rules enable the lawyer to focus on lawyering, rather than on convincing the client it is "safe" for her to reveal confidential information.

The companion to the duty of secrecy is the duty of loyalty, which Proposed Section 10.20(a) bumps up against as well. For example, consider a practitioner not certain who may or may not have the requested records or information. The practitioner's personal interest in avoiding disciplinary proceedings under Circular 230 is best served by listing everyone who *may* have the requested records or information. But doing that would directly conflict with the practitioner's obligation to the client to limit the disclosure to the minimal amount of information necessary.[8]

On a more technical note, the proposal requiring a practitioner to turn over information regarding the identity of third persons who may have the requested records or information is not subject to an exception where the practitioner believes the information is privileged. This appears to have been a drafting error. The requirement that a practitioner turn over requested "records or information" in the practitioner's possession is subject to an exception where the practitioner "believes in good faith and on reasonable grounds that the records or information is privileged." Clearly, if the proposed requirement to turn over "identity-information" is retained, an exception for privileged material should be added, although we would continue to object to the proposed rule even with the exception.

To the extent the proposed rule requires the practitioner to turn over to the Service any information the *client* has regarding the identity of any person that may possess sought-after records, the rule essentially places the practitioner in the role of an interrogator on behalf of the Service, creating an immediate conflict between the practitioner's own interest in avoiding disciplinary proceedings (by providing all required information to the Service) and the client's

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[7] "A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation...." The ABA's Disciplinary Rule DR 4-101, which has been adopted by New York State, adds an exception where disclosure is "required by law or court order." DR 4-101(C)(2). We believe it unlikely Circular 230 constitutes a "law" within the contemplation of this Disciplinary Rule.

[8] *See, e.g.*, ABA Model Rules of Professional Conduct, Rule 1.7(b); New York State Code of Professional Responsibility, EC 5-2 and 5-3 and DR 5-101.

interest in receiving objective advice regarding the Service's information request. How would the practitioner advise the client as to the client's rights and obligations with respect to responding to the practitioner's queries? If the practitioner discloses this conflict (and the practitioner may well be ethically obligated to do so), the client's sense of confidence and trust in the practitioner will surely be reduced or perhaps lost entirely. The practitioner is being asked to act simultaneously for three different (and potentially conflicting) interests: (1) the client, (2) the practitioner and (3) the Service.[9]

Proposed Section 10.20(a) also provides no guidance as to how much probing the practitioner must do in attempting to obtain from the client the identity-information. For example, if the client tells the practitioner she has no idea who has the requested information, must the practitioner push for more information? If the client is an organization, how many officers and employees must the practitioner depose to satisfy the practitioner's obligation to provide "any information ... the client has regarding the identity of any person who may have possession or control of the requested records or information"?

Quite simply, a practitioner should not be required to serve as an information-gatherer for the Service and the client should not be deprived of disinterested advice of counsel (or required to retain separate, additional counsel).

Finally, the proposed modifications imply the practitioner's obligation to submit to the Service requested records or information applies not only to records and information the *practitioner* has, but also to records and information the *client* has. The proposal is unclear on this point: the first sentence of Proposed Section 10.20(a) states that the practitioner has the obligation to turn over any requested records or information, without specifying whether the practitioner is required to collect the records and information from the client first if the practitioner does not already have them; the second sentence implies the practitioner *does* have a collection duty by requiring the practitioner to provide the substitute identity-information *if* neither the practitioner nor the client has the requested records or information. For the reasons outlined above with respect to obtaining identity-information from a client, we think it extremely inappropriate and problematic to obligate a practitioner to obtain records (or other substantive information) from a client to respond to a request issued to the practitioner. In all events, the first sentence of Proposed Section 10.20 should be revised to clarify that it applies only to records or information the practitioner already holds.

We recognize the Service cannot administer the revenue laws properly without access to information and that the proposed modifications are intended to facilitate the Service's ability to gather non-privileged information without having to resort to issuing administrative summonses to taxpayers. We believe, however, this interest does not justify creating the serious problems the proposal could present to practitioners and taxpayers. We do not suggest practitioners

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[9] In our view, a practitioner who received a request to provide the names of all persons known to the practitioner or the client that may have information sought by the Service under Proposed Section 10.20 would be faced with a significant conflict that might well require the practitioner to resign from the representation. *See, e. g.*, ABA Model Rules of Professional Conduct, Rule 1.7(b); New York State Code of Professional Responsibility, EC 5-21 and DR 5-101.

should be permitted to become uncooperative (or encourage their clients to be uncooperative beyond exercising any applicable Fifth Amendment sights) or that the Service should be encouraged to issue administrative summonses before making informal information requests. Voluntary compliance with informal requests for information clearly is the best way to proceed, when possible. But, a practitioner should be free to decide, consistent with her professional responsibilities, that it is in her client's best interest to refuse to turn over the information voluntarily, *without* the practitioner risking discipline sanctions under Circular 230.

Section 10.21. Knowledge of client's omission.

RECOMMENDATION: Section 10.21 should not be revised to require a practitioner, who learns that a client has previously made an error in or omission from a return or other document, to advise the client as to how the error may be corrected and the possible consequences of not correcting the error.

The current version of Section 10.21 requires a practitioner who learns that a client has not complied with the revenue laws or has made an error in or omission from any return or other writing submitted under the revenue laws to advise the client of the noncompliance, error or omission. Proposed Section 10.21 would also require the practitioner to go a step further and advise the client of "the manner in which corrective action may be taken, and the possible consequences of not taking corrective action."

While we agree that a client who has made a mistake should obtain advice as to how to proceed, we do not agree the burden of providing that advice should be placed on the practitioner who discovered the mistake.

Circular 230 governs a diverse array of "tax practitioners:" attorneys, certified public accountants and "enrolled agents." The Section 10.21 obligation is triggered whenever any "tax practitioner" discovers the client has made a mistake on *any* return, document, affidavit, or other paper submitted or executed under the revenue laws of the United States. In other words, the mistake need not have any connection to the matter for which the practitioner has been retained. For example, an individual qualified to provide advice on a specific matter may, while rendering advice, become aware of an instance of noncompliance, error or omission by the client on an entirely different matter. We agree that it is appropriate to require the practitioner to draw the client's attention to the mistake and we do not object to including this obligation in Circular 230. But, we do not agree the practitioner should be required, by Circular 230, to give advice [and presumably counsel] the manner in which corrective action may be taken and the possible consequences of not taking that corrective action. The practitioner may have no familiarity, experience or expertise with respect to the matter involved, the possible methods of corrective action or the potential consequences to the client of taking or not taking any such action.[10] Providing the mandated advice under these circumstances would violate the practitioner's

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[10] The practitioner may not even know enough about the facts and the governing law to determine if what the practitioner *thinks* may have been an error or omission was, *in fact*, an error or omission.

professional obligation to not provide advice the practitioner is not competent to provide.[11] In addition, the advice is likely to be considered legal advice and thus beyond the scope of what a non-attorney "tax practitioner" is authorized to provide.

Furthermore, the law governing the consequences of inadvertent errors and how, if at all, they may be corrected, is particularly unclear and, for many practitioners, rarely encountered. Even an experienced practitioner will likely be required to do substantial research to determine the avenues potentially available to the client and the "possible consequences;" and, after all that work, the practitioner may remain uncertain as to these matters. For example, practitioners regularly counsel that a taxpayer who discovers an innocent error in a previously-filed return is not obligated to file an amended return and the Service may have no obligation to accept an amended return.[12] One commentator aptly noted:

> Nor does the refusal [to amend the return and pay additional tax] constitute a willful failure to pay tax because, without a duty to correct the filed report, there apparently is no failure to pay (willful or otherwise) until the government detects the error and demands payment. [13]

It appears that the policy behind Section 10.21 is to increase the likelihood that errors will be detected and corrected. Under the current version of Section 10.21, the practitioner's only obligation is to call the error to the client's attention. This makes sense. No more should be required. The Service cannot audit every return, so the error might otherwise go undetected. If the error created a deficiency, hopefully the taxpayer will want to voluntarily correct the error and thereby minimize any interest and penalties. To increase the chances inadvertent errors will be corrected voluntarily, any practitioner who finds an error should inform the client that there was (or may have been) an error. Unless the client intended to file an incorrect return, the client is almost surely to ask (either that practitioner or another advisor) what can and should be done about it. It is not necessary to require the practitioner who discovered the error to volunteer this information – once that practitioner has alerted the client, that practitioner's policing responsibilities should end.

While we think Circular 230 should not require the practitioner to do anything further, we would not object if Circular 230 also obligated the practitioner to advise the client that he or she should seek advice as to what may be done to correct the error and minimize any potential

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11 The Service's goal of having an erroneous return corrected and the appropriate amount of tax paid is not likely to be furthered by requiring the "discovering practitioner" to provide this advice.

12 The falsity of a return cannot be cured by the filing of a correct return after the due date for filing of the original return and there is no Code provision or Treasury regulation that mandates filing an amended return. Regulations Sections 1.451-1(a) and 1.461-1(a)(3) provide that a taxpayer "should" make corrections by an amended return – not that the taxpayer "shall" or "must" do so. *See, also, Badaracco v. Commissioner*, 464 U. S. 386, 393, 397 (1984) (commenting that once a return has been filed there is no duty to file an amendment).

13 Judson L. Temple, *Rethinking Imposition of a Legal Duty to Correct Material Tax Return Errors*, 76 Neb. L. Rev. 223, 230, 231 (1997).

negative consequences.[14]

Discovery of a prior erroneous filing is to be contrasted to the situation posited by Section 10.34(b), which provides:

> A practitioner advising a client to take a position on a return, or preparing or signing a return as a preparer, must inform the client of the penalties reasonably likely to apply to the client with respect to the position advised, prepared, or reported. The practitioner also must inform the client of any opportunity to avoid such penalty by disclosure, if relevant, and of the requirements for adequate disclosure. This paragraph (b) applies even if the practitioner is not subject to a penalty with respect to the position.

Thus, in Section 10.34(b), a practitioner is told: if you are retained to give advice on a particular matter that will be reflected on a tax return, that advice must be complete – *i.e.*, the client must be warned if the position being recommended or reflected on the return might give rise to penalties and how those penalties could be avoided. Circular 230 is intended to govern practice before the Service – it is appropriate for Circular 230 to impose requirements on a practitioner retained to provide advice as to a position to be taken on a tax return.

Section 10.22. Diligence as to accuracy.

RECOMMENDATION: Revise Section 10.22 to (1) clarify the references to the "Internal Revenue Service" and the "Department of the Treasury" and to "Internal Revenue Service matters" and "matter[s] administered by the Internal Revenue Service;" and (2) incorporate into Section 10.22 the standard of due diligence as to factual accuracy set forth in the regulations under Code Sections 6694 and 6695.

Currently, Section 10.22 requires a practitioner to exercise due diligence in:

(1) preparing or assisting in the preparation of, approving, and filing of any writing, including tax returns, "relating to Internal Revenue Service matters,"

(2) determining the correctness of oral or written representations made by the practitioner "to the Department of the Treasury," and

(3) determining the correctness of oral or written representation made by the practitioner to clients "with reference to any matter administered by the Internal Revenue Service."

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[14] The practitioner who discovered the error should not, however, be required to provide the client with the name of another practitioner who could provide further advice regarding the error. The practitioner who discovered the error may not be knowledgeable regarding appropriate referrals. The arguments against requiring the practitioner to provide the advice directly apply equally to requiring the practitioner to provide a specific referral.

Because these rules are retained in Proposed Section 10.22(a), we believe this an appropriate time to make some clarifications.

First, we do not understand why clauses (1) and (3) refer to the Service, while clause (2) refers to the Treasury Department. While we recognize the Service is a division of the Treasury Department, Section 10.22 seems to be drawing a distinction between them. For example, as currently written, it could be asserted the practitioner has no due diligence obligation with respect to determining the correctness of any oral or written representations made by the practitioner to the Service. While this may be a mere technicality, it is also not clear why the Treasury Department is mentioned in this section at all. Circular 230 provides rules relating to "practice before the Internal Revenue Service;"[15] consistent with this, Circular 230 refers almost exclusively to the Service (rather than to Treasury or Treasury and the Service); and it is not clear when, if ever, a practitioner would be making oral or written representations to any branch of the Treasury Department (other than the Service) regarding a client's tax matter.

This confusion surfaces in other Circular 230 provisions as well. A similar (and equally ambiguous) reference to the Treasury Department is found in Section 10.51(d), which provides that "incompetence or disreputable conduct" for which a practitioner may be disciplined under Circular 230 includes "[g]iving false or misleading information .... to the Department of the Treasury ... in connection with any matter pending or likely to be pending before them ...."

By contrast, other Circular 230 sections refer only to the Service, when reference to the entire Treasury Department seems more appropriate. For example, Sections 10.51(e) and (h) address attempts by a practitioner to influence the official action of "any officer or employee of the Internal Revenue Service" (or intimations by practitioner that he or she is able to do so)--should not these sections also refer to officers and employees of other divisions of the Treasury Department? Section 10.29(b) provides that a practitioner who has obtained written conflict waivers from clients must provide them upon request to "any officer or employee of the Internal Revenue Service," and Section 10.69 provides that in a disciplinary proceeding the Director of Practice may be represented by "an attorney or other employee of the Internal Revenue Service." If the Director of Practice, a Treasury Department official, is charged with the enforcement of Circular 230, should not Sections 10.29(b) and 10.69 also refer to officers and employees of the Treasury Department?[16]

This confusion could be resolved by referring throughout Circular 230 to either the Service or Treasury and providing in the Section 10.2 definitions that the term refers to both the Service and Treasury.

Returning to Section 10.22, it is also unclear whether there is an intended difference in

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[15] Section 10.0. *See, also,* Section 10.2(e) (defining "practice before the Internal Revenue Service" as encompassing "all matters connected with a presentation to the Internal Revenue Service ... relating to... laws or regulations administered by the Internal Revenue Service").

[16] See also, Section 10.79(c) (referring to "the Director [of Practice] or another Internal Revenue Service official").

meaning between "relating to Internal Revenue Service matters" (the phrase used in Section 10.22(a)(1)) and "with reference to any matter administered by the Internal Revenue Service" (the phrase used in Section 10.22(a)(3)); and, if so, what that difference is. These two phrases appear in other Circular 230 sections, but this is the only section where both occur. We suspect they are intended to have the same meaning, but believe clarification is needed. We recommend the wording used in clauses (1) and (3) be made consistent.

We also recommend the standard of due diligence as to factual accuracy required under Sections 10.22(a)(1) and (2) be clarified by incorporating (or incorporating by reference) the standard of due diligence as to factual accuracy described in Regulations Section 1.6694-1(e), which governs "tax return preparers." To the extent Section 10.22(a)(1) mandates due diligence in the preparation of tax returns, those due diligence standards should be the same as those that apply under Code Sections 6694 and 6695. We also recommend following the regulations under Code Section 6694 here, because those regulations provide a fairly detailed and clear explanation of that due diligence standard.

Specifically, Regulations Section 1.6694-1(e) provides that a tax return preparer will not be liable under Section 6694 for preparer penalties for an understatement on the tax return attributable to a factual inaccuracy if the preparer relied "in good faith" on information furnished by the taxpayer.[17] The Regulations provide the return preparer "is not required to audit, examine or review books and records, business operations, or documents or other evidence to verify independently the taxpayer's information."[18] The Regulations explain when a practitioner must make some further inquiry about the accuracy of information provided by the taxpayer, and how to do so:

> the preparer may not ignore the implications of information furnished to the preparer or actually known by the preparer. The preparer must make reasonable inquiries if the information appears to be incorrect or incomplete. Additionally, some provisions of the Code or regulations require that specific facts and circumstances exist – for example, that the taxpayer maintain specific documents, before a deduction may be claimed. The preparer must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition to the claiming of a deduction.

The Regulations follow this general statement with a helpful example. The regulations under Code Section 6695 set forth an almost identical standard in describing the factual due diligence requirement for a preparer of a refund in respect of the earned income tax credit.[19]

We believe it both appropriate and beneficial to have a single standard of due diligence

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17 Regulations Section 1.6694-1(c)(1).

18 *Id.*

19 *See* Regulations Section 1.6694-2(b)(3).

as to factual matters apply to practitioners in preparing and submitting documents to Treasury and the Service and to have that standard described clearly and fully, as the regulations under Code Sections 6694 and 6695 currently do. Therefore, we recommend it be clarified that the due diligence standard under Sections 10.22(a)(1) and (2) is the same as that set forth in the Section 6694 and 6695 regulations.

Section 10.26. Notaries.

RECOMMENDATION: Section 10.26 should be revised to remove the existing ban on allowing practitioners to act as notaries in connection with matters for which they are employed as counsel, attorney or agent.

Section 10.26 currently prohibits a practitioner from taking acknowledgments, administering oaths, certifying papers or performing any official act as a notary public with respect to any matter administered by the Service and for which the practitioner is employed as counsel or agent or in which the practitioner may be in any way interested. Proposed Section 10.26 would retain these prohibitions. Both the current Section 10.26 and Proposed Section 10.26 follow the statement of the rule with a citation to an Attorney General's opinion issued in 1907. [20]

This 1907 opinion interprets a section of the District of Columbia Code that had then recently been amended by Congress. The Attorney General was asked to opine on whether the second proviso in the revised statute applied only to District of Columbia notaries or to all notaries who practice before any Department of the Federal government.

The amended section of the D. C. Code first states that the President shall have the power to appoint such number of notaries as in his discretion are required for the District of Columbia. This is followed by two provisos. The first proviso begins as follows: "That the appointment of any person as such notary public, or the acceptance of his commission as such ...." There was apparently no disagreement that this proviso applies only to D. C. notaries. The second proviso, however, does not include the magic word "such;" it reads as follows:

> And provided further, That no notary public shall be authorized to take acknowledgments, administer oaths, certify papers, or perform any official acts in connection with matters in which he is employed as counsel, attorney, or agent or in which he may be in any way interested before any of the Departments aforesaid.

The opinion reasoned that Congress makes laws covering three different "classes of business in the District ....[1] laws to be applied by the Executive Departments, situated in the District, to the whole country; [2] laws to regulate the practice and management of those Executive Departments themselves; and [3] it is the legislature of the District considered as a quasi Territory." The opinion goes on to say that when Congress passes laws it need not separate

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[20] 26 Op. Atty. Gen. 236. For convenience, the entire text of the Attorney General's opinion is set forth in Appendix A.

laws that govern one class of business from another. Accordingly, the opinion determines that the law at issue applied to all three classes – it covered local notaries (*i.e.*, class 3), it covered the practice and management of the Executive Departments (*i.e.*, class 2), and it governed the practice of individuals before those Departments (*i.e.*, class 1). Thus, "it intended to embrace all notaries who could practice before those Departments."

The opinion noted that the second proviso was added by the Senate, after the bill was passed by the House, and surmises that this addition responded to an objection raised by the Secretary of the Treasury and the Comptroller that allowing persons to act as both attorneys and notaries in matters before the Departments "'would open the doors to fraud and deceit.'"[21] The opinion reasons that had Congress intended to limit the second proviso to D. C. notaries, Congress would simply have used the word "such," and concludes the omission of the word "such" was intentional.

The opinion acknowledges the "question is not altogether free from difficulty" and "there may be room for a reasonable divergence of views in the premises" on which the opinion relies.

Although, to the best of our knowledge, the accuracy of this conclusion has never been tested in court or formally criticized by the Government, we believe there are serious doubts as to whether it is correct as a legal matter (that a provision of the D. C. Code could govern persons acting outside the District in matters administered by the Treasury) and whether it reflects the legislators' intent.

We agree that if a practitioner has some financial or other interest in a matter (beyond the practitioner's right to receive fees for the services provided), the practitioner should not act as a notary. To the extent Section 10.26 bars the practitioner from acting as a notary simply because the practitioner is also acting as the client's counsel, we think the rule is unnecessary and, if enforced, would be unfair to small firms and solo practitioners and the taxpayers who use their services. We do not think notarization of documents is, currently, subject to abuse or that there is anything inappropriate in allowing a practitioner, who is properly authorized to act as a notary, to notarize or certify documents connected to the tax services the practitioner is providing to the client. In large firms, where there may be several notaries, complying with the rule is, at worst, an inconvenience. But, for small firms and solo practitioners, where there may be only one or two notaries in the office (and they may all be working on the client's matter), the rule unduly penalizes the practitioner and the client. In our experience, practitioners have not followed this rule (mostly because they did not realize it existed) and the Service has not enforced it. We are also not aware of any complaints by taxpayers or Service personnel relating to tax practitioners who have also acted as notaries for the taxpayer. In sum, we believe that whatever benefits the rule may have or have had in the past, they are outweighed by its disadvantages.

Accordingly, we urge Treasury to reconsider Section 10.26. Assuming, for the moment, the Attorney General's interpretation of the D. C. statute is correct, there is no requirement the Federal law be repeated in Circular 230 and made a subject for practitioner disbarment, suspension or censure. Notaries are subject to standards of practice under the civil and criminal

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[21] This language is set forth in quotations in the opinion, but no formal citation is provided.

laws of the States where they are licensed; and, if Treasury uncovers improper conduct by a practitioner (or any other person) in his or her capacity as a notary, that misconduct can be reported to and processed by the appropriate state authorities.

Furthermore, if a practitioner has done something improper in his or her capacity as a notary – for example, falsely notarizing a document submitted to the Service – the practitioner would, in all likelihood, already be subject to discipline under one of the other Circular 230 provisions, such as Sections 10.50(a) and 10.51(d), which subject a practitioner to discipline for giving, or participating in any way in the giving of, false or misleading information to the Department of the Treasury,[22] and also subject to penalties under one or more Code provisions, such as Code Section 6701, which imposed a monetary civil penalty on any person who aids or assists in the preparation of any document that will support an understatement of another person's tax liability or Code Section 7206(2), which proscribes willfully aiding or assisting in the preparation or presentation of any affidavit or other document that is false or fraudulent as to any material matter. If none of these other provisions apply, we think enforcement action is best left to the notary licensing State.

Section 10.27(b). Contingent fees.

RECOMMENDATION: Revise Section 10.27(b) as follows: clarify the definition of a contingent fee; permit a contingent fee to be charged for *any* amended return or refund claim (by removing the requirement that a practitioner reasonably believe the amended return or refund claim will receive substantial review by the Service); clarify Section 10.27(b) does not prohibit charging a contingent fee for any other services not specifically addressed, such as representing a taxpayer in an audit or in filing a request for a private letter ruling; add a targeted anti-avoidance rule to prohibit specified types of abuses; and clarify Section 10.27(b) applies without regard to whether the person paying the contingent fee to the practitioner is the actual "taxpayer."

Under current Section 10.27(b), a practitioner may not charge a contingent fee for preparing an original tax return, but may charge a contingent fee for preparing an amended return or claim for refund if the practitioner reasonably anticipates (at the time the fee arrangement is entered into) that the amended return or refund claim will receive substantive review by the Service. Proposed Section 10.27(b) repeats these prohibitions and *adds* that a contingent fee also could not be charged for:

(1) "any advice rendered in connection with a position taken or to be taken on an original tax return," or

(2) "any advice rendered in connection with a position taken or to be taken on an amended tax return or a claim for refund ....[unless] the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended tax

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22 Other examples are Section 10.22(a)(1), which requires a practitioner to exercise due diligence in preparing or assisting in preparing any document, affidavit or other paper relating to Internal Revenue Service matters, and Section 10.22(a)(2), which requires a practitioner to exercise due diligence in determining the correctness of any written representation made by the practitioner to Treasury.

> return or refund claim will receive substantive review by the Internal Revenue Service."

The Proposed Rules would change the definition of a "contingent fee." Currently, a contingent fee "includes any fee that is based on a percentage of the refund shown on a return, a percentage of the taxes saved, or that otherwise depends on the specific result attained."[23] Under Proposed Section 10.27(b), 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 in a refund claim is sustained by the Service or in litigation. A contingent fee includes an indemnity agreement, a guarantee, rescission rights, insurance, or any other arrangement under which the taxpayer or other person would be entitled to be compensated or reimbursed by the practitioner in the event a position taken on a tax return or a refund claim is not sustained, or any other arrangement that has a similar effect.

We applaud these changes.

Definition of a Contingent Fee

We believe the refined contingent fee definition is a significant and necessary improvement. Limiting a contingent fee to a fee based upon the *ultimate* success of the position taken is appropriate. This new definition correctly insures the prohibition applies only when the amount of the fee is subject to change as a result of whether the taxpayer's position is sustained – *i.e.*, contingent upon the success of the claim. Thus, as we interpret this new definition, a fee would *not* be a "contingent fee" solely because it is based upon the amount of the tax liability or refund shown on a return or refund claim or because the practitioner uses a so-called "value billing" method where the amount of the fee is based upon the practitioner's assessment of the value of her work to the taxpayer, rather than upon the precise numbers of hours worked. We believe it would be helpful if this were stated explicitly in Section 10.27(b). If our interpretation of the new definition is incorrect, clarification should be provided.

Secondly, we strongly support the second half of the new definition, essentially describing "disguised contingent fees." We believe this extension necessary to insure the rule applies in the manner intended and practitioners are on notice the prohibition may not be circumvented by disguising the fee contingency. We think examples illustrating disguised contingent fees would be helpful and propose the following example:

Proposed Example:

Facts: A practitioner issues an opinion on a transaction and receives an agreed-upon fee at the time the opinion is issued. The transaction involves the creation of a new special purpose entity whose only activity will be in connection with this transaction. The practitioner and client

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[23] Current Section 10.27(b).

expect that, if the tax treatment is successfully challenged, the special purpose entity will be dissolved. Before the amount of the fixed fee for the opinion was agreed upon, the practitioner and client agreed the practitioner would be engaged as the tax adviser for the new entity, and, as the entity's tax adviser, would receive a fixed annual retainer (for so long as the entity remained in existence) and would also be entitled to charge additional fees at customary rates for any work actually performed for the entity. The amount of the retainer is significant and is far greater than industry standard.

Analysis: Under these circumstances, the retainer properly is viewed as a disguised contingent fee --the retainer does not represent compensation for any additional services because the practitioner may charge for those separately and the practitioner will continue to receive the retainer unless and until the tax treatment is successfully challenged. Accordingly, this arrangement has the same effect as a contingent fee and would be a violation of Section 10.27(b).

The contingent fee definition should be modified so that a contingent fee includes not only (i) a fee that is based in whole or in part upon whether the taxpayer's position is upheld once challenged, but also (ii) a fee based in whole or in part on whether the position *never* is challenged (because this is another way of basing the amount of the fee on whether the asserted tax position is successful). This extension could be accomplished by adding at the end of the first sentence of the definition the following ", after being challenged, or is never challenged."

We also propose clarifying that a fee for tax return preparation will not be a "contingent fee" solely because the practitioner agrees (prior to payment of the fee) that, if the taxpayer's position is audited or challenged by the Service, the practitioner will defend the taxpayer (or arrange for the taxpayer to be defended) without charge or at a reduced rate. Although the practitioner is, in essence, agreeing to refund a portion of the initial fee (by providing additional services free of charge or at a discount), this "refund" will be made whether or not the taxpayer's position is ultimately upheld or defeated. Therefore, the fee adjustment is *not* dependent on the ultimate success of the tax position and thus the fee is not contingent.

When a Contingent Fee May be Charged For an Amended Return or Refund Claim

Our next point relates to the requirement that the practitioner "reasonably anticipates" that the amended return or refund claim will receive "substantive review" before the practitioner may charge a contingent fee. We fully agree with Treasury that contingent fees should be prohibited in connection with preparing original returns. Proposed Section 10.27(b) would permit a contingent fee to be charged in connection with an amended return or refund 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 Service.

We recognize the "reasonably anticipates ... substantive review" requirement is contained in both the current and proposed versions of Section 10.27, and represents a compromise arrived at in 1994. Treasury's initial proposal was that contingent fees be permitted for an amended return or refund claim only if the practitioner reasonably anticipated, at the time the claim was filed, that the claim would be denied by the Service and then litigated

by the client.[24] Commentators objected that this standard would be difficult for the Service to administer and for practitioners to apply. Treasury responded by issuing the rule in its current form and stating in the Preamble to the final rule that the determination of whether the standard was met would be made on a "case-by-case basis."[25] The Preamble explained:

> Treasury continues to believe that a rule restricting contingent fees for preparing tax returns supports voluntary compliance with the tax laws by discouraging return positions that exploit the audit selection process.[26]

We agree a practitioner should not benefit monetarily by taking advantage of the Service's resources being overburdened and its mission understaffed. Nevertheless, we believe the "reasonably anticipates ... substantive review" test is vague and potentially unfair to taxpayers seeking advice and their practitioners.

First, what does "substantive review" mean? Does it mean the refund claim will be reviewed by one Service employee? by two? That the employee will spend more than "x" number of minutes reading the claim? researching the claim? Does it mean the claim will be passed up the chain to a supervisor or that the local Regional Counsel field office will be contacted? Even if Circular 230 were to answer these questions, most practitioners have no way to "reasonably anticipate" which of these events will take place. Most practitioners simply do not know how the Service processes and reviews amended returns and refund claims.

The substantive review test also tends to favor questionable and aggressive claims over well-supported claims. For example, assume the practitioner includes with the amended return or refund claim a position paper explaining the factual and legal basis for the position. If the paper is so convincing the first person who reads it within the Service grants the refund without further inquiry, should the practitioner be denied the right to charge a contingent fee? Should contingent fees be limited to amended returns that are controversial and likely to be objectionable to the Service? We think not.

Finally, we believe most practitioners assume that any refund claim involving a significant amount of money will receive meaningful review. Does that view alone support charging a contingent fee for any amended return or refund claim involving a significant amount of money? If so, how much is "significant?"

Taking these concerns into account and considering the role of refund claims, we believe contingent fees should be permitted for *any* refund claim. We suspect, although we have no hard evidence, substantially all taxpayers filing refund claims are not playing the audit lottery; and, although, as indicated above, we do not know precisely how the Service processes refund claims, we expect overly aggressive or questionable positions taken on refund claims are

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24 T.D. 8545 (June 20, 1994).

25 T.D. 8545.

26 T.D. 8545.

far less likely to slip through undetected than overly aggressive or questionable positions taken (or hidden) on original returns. The "reasonably anticipates... substantive review" test seems unnecessary if, as we expect, most refund claims fall into one of two categories: either the claim involves enough money to attract Service review or the claim is not large enough to be of significant concern. Perversely, the smaller claims, which may not receive in-depth reviews, are more likely to have been filed by or on behalf of taxpayers who would not be able to pay for the refund advice without a contingent fee arrangement.

We believe practitioners that abuse contingent fee arrangements likely will be simultaneously violating one or more other Circular 230 provisions – such as, Section 10.22(a)(1) requiring the practitioner to exercise due diligence in preparing and filing tax returns, Section 10.34(a) requiring the practitioner to determine a return position has a realistic possibility of success on the merits (or is not frivolous and is adequately disclosed), and Section 10.34(b) requiring the practitioner to advise a client concerning potential penalties reasonably likely to apply with respect to a return position. Therefore, these practitioners sanctioned and their behavior discouraged without shutting off many taxpayers' only means of obtaining advice necessary to correct an initial overpayment or error.

Ability to Charge Contingent Fees for Other Services

Neither the current nor proposed Section 10.27(b) addresses whether contingent fees may or may not be charged in other situations, such as for services provided in connection with an audit or assertion of a deficiency by the Service (whether relating to an original return, an amended return or a refund claim). Presumably, because contingent fees are not prohibited in other contexts, they are permissible, but we think this principle should be clarified.

We believe the policy justifying the contingent fee prohibition does not extend to banning contingent fee arrangements for services rendered in audit and deficiency/contest situations. These situations are particularly appropriate contexts in which to permit a contingent fee because a taxpayer facing an audit or deficiency notice may be unable to pay a non-contingent fixed fee or find a practitioner willing to represent the taxpayer in the tax dispute without a contingency fee clause. There can be no doubt the "matter" will receive substantive Service review. Contingent fee arrangements have long been used in the context of legal contests and are regulated (and often encouraged) by many state bar associations and state rules of professional responsibility and professional ethics, as well as the ABA Model Rules of Professional Conduct.[27] For similar reasons, we also believe contingent fees should not be prohibited in connection with preparing and filing a private letter ruling request or a request for so-called "9100 relief" to permit the filing of a late election.

It could be made clear that contingent fees are not prohibited in these other circumstances by adding the following sentence to Proposed Section 10.27(b): "Except as specifically provided in this Section 10.27(b), a practitioner is not prohibited from charging a contingent fee for any advice or services rendered to a taxpayer."

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[27] *See, e.g.*, ABA Model Rules of Professional Conduct, Rules 1.5 (c)and (d). *See, also,* New York State Code of Professional Responsibility, EC 2-20 and DR 2-106(C).

Add Anti-Avoidance Rule

We believe an additional rule should be promulgated to prevent practitioners from circumventing the prohibition on charging a contingent fee for preparing an original return by taking advantage of the right to charge a contingent fee in connection with an amended return, audit or assertion of a deficiency. The abuse we are concerned with is illustrated by the following example:

> A practitioner agrees with a client to prepare an original return and represent the client in any contest relating to the return. The practitioner charges a fixed (but far below market) fee for the original return. The practitioner fully expects (in fact, intends) that at least one position on the return will be challenged and settled, with the client paying the Service something less (but perhaps not far less) than 100 cents on the dollar. Pursuant to a prior agreement, when the return is audited, the practitioner receives some percentage (say, 40%) of the savings ultimately obtained.

We recognize it could be argued this arrangement is really a disguised contingent fee charged for preparing the initial return. To eliminate any uncertainty, however, and approach the matter directly, we proposed adding the following language to Proposed Section 10.27(b):

A contingent fee may not be charged for advice or service rendered in connection with an amended tax return, refund claim, audit, assertion of a deficiency or administrative or judicial proceeding ("subsequent services") if

(i) the practitioner prepared the original return or rendered any advice in connection with a position taken on the original return, and

(ii) at the time the initial services or advice were rendered, there was an explicit or implicit agreement that if the practitioner (or any member, employee or agent of the practitioner's firm or company) performed any subsequent services relating to the return, the practitioner (or such other person) would charge a contingent fee for all or part of those subsequent services.

This restriction would discourage tax practitioners from facilitating overly aggressive return positions – in essence, playing the "settlement lottery" or the "litigation lottery," both of which are pernicious to our tax system.

While other Circular 230 provisions, and other Code provisions, such as Code Sections 6694 and 6701, might also restrict this conduct, those provisions are not aimed at the special considerations that arise in connection with contingent fees. In addition, because contingent fees in these cases raise special ethical issues, we believe it appropriate to address these concerns in Circular 230. For example, Sections 6694 and 6701 would authorize only imposing a monetary fine on the practitioner, while Circular 230 would authorize censure, suspension or disbarment. [28]

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[28] As discussed below, Circular 230 would also authorize "reprimand."

Contingent Fees for Issuing Marketing Opinions

Finally, it is not clear how Proposed Section 10.27(b) would apply to fees for issuing a marketing opinion. Under the current rule, it seems fairly clear the practitioner may not charge *a taxpayer* a contingent fee for preparing *that taxpayer's* return. Proposed Section 10.27(b) extends the prohibition to "any advice rendered in connection with a position taken or to be taken on an original tax return." This extension raises the question of whether the contingent fee prohibition applies to an opinion issued to a client (*e.g.*, a tax shelter promoter) addressing a tax position to be taken by a third party (*i.e.*, the person who purchases the tax shelter product from the client/ promoter that obtained – and published – the opinion).[29] The practitioner's fee in that case may be linked, indirectly, to the success of the position to be taken by the third-party taxpayer. For example, suppose the third-party taxpayer pays the promoter a fee that is contingent upon the taxpayer realizing the hoped-for tax benefits, and the promoter enters into a back-to-back contingent fee arrangement with the practitioner. If the third-party taxpayer's tax position is successfully challenged, the promoter pays a fee refund to the taxpayer and the practitioner pays a fee refund to the promoter. Does Proposed Section 10.27(b) apply?

Proposed Section 10.27(b) should be clarified to apply to any arrangement where the practitioner's fee is contingent upon the success of any taxpayer's tax position. Proposed Section 10.27(b) is designed to remove the incentive for a practitioner to participate in or encourage others to participate in the audit lottery. It makes no difference who pays the contingent fee to the practitioner. The concern is whether the practitioner has a personal economic stake in the audit lottery results. [30]

Section 10.28. Return of Client's Records.

RECOMMENDATION: Do not add Proposed Section 10.28 because a practitioner should be able to exercise rights granted under state law to assert an attorney's lien on a client's records to enforce collection of an unpaid fee.

This new section requires the practitioner, at a client's request, to promptly return all records belonging to the client, regardless of whether there is an unresolved dispute over the practitioner's fee. We believe this provision conflicts with the well-established rule that, during the pendency of a fee dispute, an attorney has a lien upon client records and is not required to

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[29] Although we use a tax shelter transaction as an example, we believe that the contingent fee rules should apply to any marketing opinion, whether or not the underlying transaction is a tax shelter and whether or not the opinion would be subject to Proposed Section 10.33 or 10.35.

[30] In this example, there is a contingent fee arrangement between the taxpayer and the promoter. The new tax shelter disclosure regulations (Temporary Regulations Section 301.6011-4T) may reduce significantly or eliminate entirely the frequency of these contingent arrangements because a contingent fee arrangement counts as one of six factors that trigger a disclosure requirement under Code Section 6011. Nevertheless, a single contingent fee could be arranged between the promoter and the practitioner, based upon the success of the third-party's tax position.

return the records until the dispute has been resolved or adequate security has been posted.[31] The ABA Committee on Ethics and Professional Responsibility agrees that the attorney's right to assert a lien is a matter of state law and not an ethical issue.[32] Both the ABA Model Rules of Professional Conduct and the ABA Model Code of Professional Responsibility provide that a lawyer that has obtained a lien under local law may enforce that lien.[33] A practitioner should not be subject to sanctions under Circular 230 because the practitioner exercises rights granted to her under state law to collect fees for services she has performed. Where the client needs the records in connection with a pending litigation or other matter, the client may turn to the court, an objective arbiter, for relief. The Service is in no way prejudiced.[34]

We do not suggest that a practitioner may or should be allowed to retain (permanently or temporarily) funds the client has given to the practitioner for payment to the Federal government.[35] Proposed Section 10.28 is not addressed to withholding funds, because the proposed section covers only client's "records." Withholding funds is, instead, specifically proscribed by Proposed Section 10.51(g) (and current Section 10.51(e)), which provides that a practitioner may be censured, suspended or disbarred for the "[m]isappropriation of, or failure

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31 *See, e. g.*, Restatement (Second) of Agency, Section 464(b) and Comment h. (unless he agrees otherwise, an "attorney-at-law has the further right to retain possession of money, goods, or documents until he is paid the amount due him ..." and his security interests are not affected by a termination of the attorney/client relationship); Restatement (Second) of Security, Section 62(b) and Comment on Clause (b) (an attorney at law has a general possessory lien upon the papers and other chattels of his client as security for the general balance due him for professional services and disbursements and he "cannot be compelled to allow the inspection of papers, to give discovery or to produce them in evidence where his lien will thereby be impaired."); *Pomerantz v. Schandler*, 704 F. 2d 681 (2d. Cir. 1983)("The issue before us, the nature and extent of an attorney's lien, is controlled by federal law. ... It is settled that an attorney may claim a lien for outstanding unpaid fees and disbursements on a client's papers which came into the lawyer's possession as the result of his professional representation of his client." A court normally will require the attorney to turn over the papers subject to the lien only after the client has paid the outstanding fees or posted adequate security for the payment. "Indeed, we have held failure to impose such conditions to be an abuse of discretion. Otherwise, an unconditioned turnover would weaken the lien.") (citations omitted); *Marsh, Day & Calhoun v. Solomon*, 529 A. 2d 702 (Conn. 987) (applying Connecticut law) (an attorney has a self-executing lien on client's papers and files until his fee has been paid and only in rare circumstances will a court order the papers be released without the furnishing of adequate security). Thus, the self-executing attorney's lien is respected in most if not all states as well as in cases governed by federal law.

32 ABA Comm. on Ethics and Prof'l Responsibility, Informal Op. 86-1520 (1986), and the underlying ABA Informal Op. 1461 (1980) (withdrawn on other grounds by ABA Opinion 86-1520).

33 *See* ABA Model Rules of Professional Conduct, Rules 1.8(j)(1) and 1.15(b); ABA Model Code of Professional Responsibility, DR 5-103(A)(1).

34 The move by more and more states to adopt laws requiring arbitration of disputes between attorneys and clients demonstrates the importance of leaving this matter to be resolved under state law. A fee dispute is a state law matter and state law should determine each party's rights and obligations with respect to resolving the dispute. The new arbitration rules will need to address what happens to the attorney's common law lien once arbitration has commenced. Federal involvement is inappropriate.

35 Under the laws cited in the prior footnotes, an attorney would *not* have a lien on the funds because the funds would be given to the attorney for the express purpose of delivering those funds to the Federal government.

properly and promptly to remit funds received from a client for the purpose of paying taxes or other obligations due the United States."[36]

Section 10.29. Conflicting Interests.

RECOMMENDATION: Clarify that a "potential conflict" is limited to a divergence in the parties' economic interests that the practitioner knows or has reason to know exists currently or is likely to develop in the near future; provide guidance as to the extent and manner of the required disclosure of a conflict between two clients and the precise form and content of a waiver; add illustrations of when representation of a client may be limited by a practitioner's own interests and how a practitioner could disclose the risks and reasonably determine that the representation will not be adversely affected.

Current Section 10.29 provides that a practitioner shall not

> represent conflicting interests ... except by express consent of all directly interested parties after full disclosure has been made.

Proposed Section 10.29 makes significant changes.

First, under Proposed Section 10.29(a), a practitioner may not represent "potential conflicting interests" unless

(1) the practitioner "reasonably believes that the representation of any party ... will not be adversely affected" and

(2) all "parties represented by the practitioner who have an interest in the matter" give express written consent "after the practitioner has fully disclosed the potential conflict."

Second, under proposed Section 10.29(c), a practitioner may not represent a party if the representation "may be materially limited by the practitioner's own interest" unless

(1) the practitioner "reasonably believes the representation will not be adversely affected" and

(2) the client consents "after the practitioner has fully disclosed the potential conflict, including disclosure of the implications of the potential conflict and the risks involved."

We have several comments and questions regarding Proposed Section 10.29.

We focus first on Proposed Section 10.29(a), which governs conflicts between two or more clients. Proposed Section 10.29(a) would be triggered whenever two or more clients have

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[36] This is one of the illustrated types of "incompetence and disreputable conduct" for which a practitioner may be disciplined under Circular 230. *See, generally,* Section 10.51 and Proposed Section 10.51.

"potential" conflicting interests, and would require the practitioner to, among other things, "fully disclose the potential conflict." It is not clear what "potential" means in these two instances. What are "potentially conflicting interests"? How creative does the practitioner need to be in determining what potential conflicts may arise? How far into the future should the practitioner look? And, how much detail is necessary to "fully disclose the potential conflicts"? Does the practitioner need to describe all the potential conflicts that may arise in detail or is one general statement enough? Finally, must the written consent signed by the client list the potential conflicts the practitioner has described or can it be a general consent waiving all conflicts?

Take the situation where two or more persons retain the practitioner to advise them both *e.g.*, a husband and wife, a family that owns and operates a family business or two unrelated individuals who operate a business as a partnership. Before commencing the representation, Proposed Section 10.29(a) would require the practitioner to advise them they may have conflicting interests and may want to retain separate tax advisors. If the individuals ask the practitioner to elaborate on what the conflicts might be, the practitioner should do so. But, if the individuals have no questions or concerns and the practitioner has no reason to suspect their interests will diverge, the practitioner should not be obligated to describe all variations of potential conflicts that may arise. The term "potential" is too vague and places an undue burden upon the practitioner. A description of potential conflicts likely will only confuse and irritate the clients. Spouses need not be reminded of the possibly of a divorce at some future time and siblings operating a family partnership need not be warned about the possibility of a judicial accounting. We believe the practitioner needs to know of some actual conflict before the practitioner has a duty to fully disclose and obtain written consents. Where the client is a closely held business or a married couple filing a joint return, there are innumerable "potential" conflicts. We believe it unrealistic, inappropriate and potentially harmful to require a practitioner to speculate what types of conflicts may arise and the speculation itself may generate problems between the clients where none previously existed.[37]

Representation of a partnership, a Subchapter S or Subchapter C corporation or a trust or estate all have the potential for conflicts simply because more than one individual is involved and several may be affected. For example, a deficiency may be asserted by virtue of the disallowance of a deduction. If the practitioner succeeds in sustaining the deduction, a

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[37] Consider a husband and wife who retain a practitioner to prepare their joint income tax return. The husband has invested in some Florida properties that are rented out and intends to take deductions for depreciation and mortgage interest. The practitioner has no reason to suspect the facts described by the husband are not true and no reason to suspect any marital discord. Nevertheless, based upon experience, the practitioner knows sometimes one spouse falsifies something on a joint return and the other spouse may subsequently seek "innocent spouse" relief; and the practitioner also knows marriages do not always last forever. Can the practitioner simply advise them that, like all married couples, they are not required to file jointly, they may at some point have conflicting interests and that if this concerns them they may want separate advisors? Or, does the practitioner have to tell them the facts provided by the husband may turn out to be untrue, the properties may not in fact be owned by him, or they may not be rented out but rather his former wife (or, worse, his girlfriend) may be living there, and the deductions may be disallowed, they may both be charged with tax fraud, the wife may want to seek innocent spouse relief and request the practitioner to testify as a witness on her behalf and that it may be crucial to her case to prove that the husband knowingly hid the truth from her? Sounds extreme? What if it just happened with another client of the practitioner the year before?

shareholder (or partner) may have wished to argue that the expenditure was personal to another shareholder (or partner) and should not have been deducted in the first instance. Only when the shareholder or partner makes this position known to the practitioner does the conflict become apparent; and that is the occasion for the practitioner to disclose and discuss the conflict.[38]

In light of these concerns, we believe it important to clarify the meaning of "potential." We suggest a potential conflict be defined as any divergence in the parties' economic interests that the practitioner knows or has reason to know exists currently or is more likely than not to develop in the near future. Guidance also should be provided as to the extent and manner of the necessary disclosure. In this regard, we note the difference between Proposed Section 10.29(a)(2), which states simply that the practitioner must have "fully disclosed the potential conflict," and Proposed Section 10.29(c), governing conflicts between the practitioner and the client, which provides that the practitioner must have "fully disclosed the potential conflict, including disclosure of the implications of the potential conflict and the risks involved."

We also have concerns about the new requirement, in Proposed Section 10.29(a)(2), that all parties with an interest in the matter "expressly consent in writing" to the representation. State bars have different rules as to whether consents must be in writing, as well as the substance of those required written consents.[39] Circular 230 practitioners should not be required to obtain written consents unless and until there is an actual or apparent conflict. The written consent should not describe the conflict or situations in which they might become problematic. In some cases, the mere recitation of a potential conflict may be a damaging and unauthorized disclosure. We also question the rationale for omitting any written consent requirement from Proposed Section 10.29(c). It seems especially important, particularly where the potential or actual conflict is between the practitioner and the client (as contrasted to being between two of the practitioner's clients), to obtain and preserve written proof the conflict has been adequately disclosed and consented to.

Our final comments on Proposed Section 10.29 relate to subsection (c), which applies when representation of a party before the Service may be materially limited by the practitioner's own interests. Examples illustrating when this problem might arise, the grounds on which the practitioner could reasonably determine that the representation will not be adversely affected and how the practitioner could comply with the requirement of full disclosure of the risks involved should be added. We suggest the following two examples:

Proposed Examples

Example 1: A practitioner issued a more likely than not tax opinion and now the

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38 *See, e.g.*, New York State Code of Professional Responsibility, DR 5-105 and 5-109; 22 NYCRR Sec. 1200.28. Where a conflict is apparent from the start, the practitioner may, in certain cases, determine that joint representation is inappropriate notwithstanding full disclosure and written consents.

39 *Compare*, New York State Code of Professional Responsibility, EC 5-16 (requiring client's consent, "preferably in writing") with California Bar Rules, Professional Conduct, R 3-310 (C)(2) (requiring client's written consent); and ABA Model Rules of Professional Conduct Rule 1.7(b)(2) (simply requiring client's consent).

consummated transaction is being challenged on audit. The practitioner is concerned that if the issue is litigated, the practitioner's opinion will be publicized and his reputation adversely affected. For that reason, the practitioner greatly prefers the matter be settled during the audit stage.

Example 2: A practitioner issued more likely than not opinions to three unrelated taxpayers on three similar, but unrelated, transactions. The practitioner reasonably expects that all three taxpayers will be audited. The facts of each taxpayer's transaction are slightly different and the first taxpayer to be audited has the strongest factual case. The practitioner is confident that, on this taxpayer's facts, the tax position set forth in her opinion would be upheld if it were litigated and that the favorable court decision would help the practitioner to obtain favorable settlements for his other two clients. For that reason, the practitioner prefers that this first case be litigated, rather than settled.

Sections 10.33 and 10.35: Tax shelter opinions.

Generally, Proposed Sections 10.33 and 10.35 establish standards a practitioner must satisfy to issue an opinion on the tax consequences of any "tax shelter" defined in Circular 230. The current Section 10.33 applies to all tax shelter opinions used in marketing. The Proposed Rules would revise Section 10.33 and add a new Section 10.35. Proposed Section 10.33 would apply only to tax shelter opinions (i) used in marketing *and* (ii) that do not conclude that the tax treatment of the tax shelter items is more likely than not (or higher) the proper treatment. Proposed Section 10.35 would apply to all tax shelter opinions that provide a more likely than not or higher degree of assurance (whether or not used in marketing).[40]

These proposals are part of a multi-pronged attack on tax shelters that includes: (i) the new tax shelter disclosure, registration and listing regulations (the corporate taxpayer disclosure regulations under Code Section 6011, the tax shelter registration regulations under Code Section 6111 and the investor list maintenance regulations under Code Section 6112)[41] and Notice 2000-15[42] (described "listed transactions" for purposes of the new tax shelter regulations), (ii) the formation of the new Office of Tax Shelter Analysis, (iii) periodic updates to Notice 2000-15 and (iv) legislative proposals to increase understatement penalties attributable to tax shelters.

We agree the best way to stem the popularity of tax shelters is to change the cost/benefit calculus for taxpayers. We previously have expressed our view that this cost/benefit adjustment could best be accomplished by imposing strict liability penalties for underpayments attributable to a tax shelter.[43] Strict liability penalty imposition would eliminate a taxpayer's ability to use a

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[40] Attached hereto, as Appendix B, is a side-by-side comparison of each provision of Proposed Section 10.33 and Proposed Section 10.35.

[41] Temporary Regulations Section 1.6011-4T; Temporary Regulations Section 301.6111-2T; Temporary Regulations Section 301.6112-1T.

[42] Notice 2000-15; 2000-12 I.R.B. 826.

[43] *See, e.g.*, New York State Bar Ass'n Tax Section, Report on the Temporary and Proposed Tax Shelter Regulations, November 16, 2000, reprinted at 2000 TNT 225-17; Letter from Robert H. Scarborough on

"more likely than not" tax opinion to avoid penalties pursuant to Code Sections 6662 and 6664 and would facilitate a shift in the lawyer/client dialogue towards a focus on the most objective, thorough and sober analysis of the proposed transaction.

The Proposed Rules aim to effect this shift to more objective opinions by focusing on the practitioner, rather than the taxpayer. By establishing rules requiring an opinion intended to provide penalty-protection (*i.e.*, a "more likely than not" or stronger opinion) be an objective, realistic and complete assessment of the merits of the taxpayer's positions, Proposed Section 10.35 is designed to shut down the supply of opinions that do not satisfy these high standards. Under the Proposed Rules, a practitioner who provides a nonobjective, unrealistic or incomplete opinion will be subject to censure, suspension or disbarment.[44] The Preamble reveals Treasury and the Service will simultaneously attack the demand (or taxpayer) side of the "opinion market," by revising the regulations under Code Sections 6662 and 6664 to provide that opinions that do not meet Circular 230 standards may not be used to establish the taxpayer had the "reasonable belief" or "reasonable cause and good faith" necessary to avoid penalties for tax shelter participation. Generally, we applaud these efforts.

Before considering the specifics of Proposed Sections 10.33 and 10.35, we think it important to identify what these rules are intended to accomplish. Articulating the goals will lay the ground work for assessing (1) whether the Proposed Rules effectively accomplish these goals, (2) what changes, if any, should be made, and (3) whether and to what extent any of these goals should be addressed in other tax law provisions (instead of, or in addition to, Circular 230).

We also believe these goals should be set forth in Circular 230. The Proposed Rules are extremely complicated – they are, in some respects, highly technical and, in other respects, quite general and subject to a variety of interpretations. While we hope our comments, along with other comments submitted to Treasury and the Service, will assist in making the final rules more workable, we firmly believe it not possible to write a single set of rules that will work in every situation without raising any doubts as to how the rules apply and whether they have been adequately complied with. Therefore, we believe it would be extremely valuable if the rules began with a set of guiding principles and goals. In a later section of this Report, we suggest the Circular 230 disciplinary provisions specifically provide these principles and goals be taken into account in determining whether a practitioner who has violated Circular 230 should be sanctioned and, if so, what the sanction should be. [45]

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behalf of New York State Bar Ass'n Tax Section, July 25, 2000, reprinted at 2000 TNT 157-41; New York State Bar Ass'n Tax Section, Report on Proposed Amendments to Circular No. 230, July 31, 2000, reprinted at 2000 TNT 150-31; New York State Bar Ass'n Tax Section, Report on the Treasury's Proposal to Codify the Economic Substance Doctrine, July 24, 2000, reprinted at 2000 TNT 157-41.

44 As discussed below, the practitioner could also be subject to "reprimand."

45 For example, if the practitioner reasonably believed in good faith at the time of the violation that his or her actions complied with the Rules' requirements and were consistent with the Rules' principles and goals, that good faith belief would be taken into account in determining how, if at all, the practitioner should be sanctioned.

With that preface, what are the goals of Proposed Sections 10.33 and 10.35? We have developed the following, likely incomplete, list:

1. Protect taxpayers that may otherwise naively rely on an opinion that, to them, appears to conclude the transaction works, although in reality the opinion is full of holes, caveats and unreasonable assumptions.

2. Protect taxpayers that may otherwise believe that a generic marketing opinion or a less than more likely than not opinion will immunize them from penalties.

3. Deter taxpayers from entering into inappropriate transactions by alerting them to the real issues and weaknesses in the tax analysis and the practitioner's actual assessment of the merits of the tax position (after taking into account all the facts and all the law).

4. Make it more difficult (or even impossible) for a sophisticated taxpayer to obtain a craftily-drafted opinion the taxpayer hopes will protect it from substantial understatement and negligence penalties (under Code Sections 6662 and 6664) if the tax shelter is "picked-up" on audit.

This last goal is part of a larger effort to prevent sophisticated taxpayers from being able to enter into aggressive transactions without facing any realistic threat of penalties by simply purchasing a more likely than not (or higher) penalty-protection opinion from an obliging tax practitioner. (Of course, the ultimate goal is to prevent taxpayers from entering into overly aggressive transactions in the first place. That was what the penalty provisions of the Code were intended to accomplish.) As indicated above, Treasury and the Service intend to curb taxpayers' demand for craftily-drafted opinions by providing, under the Code Section 6662 and 6664 regulations, that those opinions will not provide penalty protection.[46]

Thus, Circular 230 protects both taxpayers and the fisc. It is interesting to consider that the reasonable cause and good faith defenses under Code Sections 6662 and 6664 were designed initially to protect both taxpayers and the fisc. Generally, these defenses allow a taxpayer to avoid penalties if the taxpayer genuinely relied in good faith on advice from a practitioner that concluded the taxpayer's position was more likely than not proper. To the extent Circular 230 is aimed at preventing an abuse of these defenses, it is important to keep in mind that there are really two separate questions to be answered: (1) what should the requirements be for an opinion to support a Code Section 6662 or 6664 reasonable cause defense and (2) how should each specific requirement be implemented and enforced – *e.g.*, in the Section 6662 and 6664 regulations, in Circular 230, or in both?

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[46] These rules will (hopefully) benefit not only the fisc *but also* the ethical tax practitioner, who will be able to provide an avaricious client with a concrete reason the practitioner is not willing to issue (and the client should not want) an opinion that relies on unsubstantiated facts or unreasonable assumptions.

A. When is written advice subject to Proposed Section 10.35 --Definition of a "tax shelter opinion"

One of the most important and confusing aspects of the Proposed Rules is determining when written advice is subject to Proposed Section 10.35. We begin by describing what the Proposed Rules would provide; then, we discuss the problems we envision with those rules; and finally, we propose various solutions and assess their potential advantages and disadvantages.

What the Proposed Rules Would Provide

Proposed Section 10.35 applies to any "tax shelter opinion" that concludes the Federal tax treatment of a tax shelter item or items is more likely than not (or a higher standard) the proper treatment.[47] A "tax shelter opinion" is defined (in Proposed Section 10.35(c)(4))as "written advice by a practitioner concerning the Federal tax aspects of a tax shelter item or items. ..."[48] A "tax shelter" is defined, by reference to Code Section 6662(d)(2)(C)(iii) (which defines a tax shelter for purposes of the substantial understatement penalty), as

(1) a partnership or other entity,

(2) any investment plan or arrangement, or

(3) any other plan or arrangement,

if a significant purposes of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.[49]

Proposed Section 10.35 applies only if (i) the transaction is a "tax shelter" for purposes of the Code Section 6662 substantial understatement penalty and (ii) the opinion gives the level of assurance (*i.e.*, more likely than not or higher) required to establish a reasonable cause/good faith

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47 Proposed Section 10.35(a).

48 The definition also includes special rules when the tax advice is set forth in offering materials, but those rules are not relevant to the immediate discussion. Because those rules are also used in Proposed Section 10.33, those rules are discussed in the following section of this Report, which addresses the scope of Proposed Section 10.33.

49 Under current law, a taxpayer may avoid a substantial understatement penalty under Code Section 6662 with respect to an item attributable to a "tax shelter" if, among other things (i) there was "substantial authority" for the taxpayer's treatment of the item and (ii) the taxpayer reasonably relied in good faith on the opinion of a professional tax advisor stating that there is a greater than 50-percent likelihood that the taxpayer's treatment of the item will be upheld if challenged (*i. e.*, that the taxpayer's treatment of the item was more likely than not the proper treatment). Code Section 6662(d)(2)(C)(i) and Regulations Section 1.6662-4(g) (for non-corporate taxpayers) and Code Section 6664(b) and Regulations Section 1.6664-4(e)(2) (for corporate taxpayers). These rules are generally referred to as "the reasonable cause and good faith exception." The regulations under Section 6662 and 6664 set forth certain minimum requirements that an opinion must meet to be used for this purpose. Those requirements are similar to the requirements of Proposed Section 10.35, but less detailed and less specific about precisely what must be discussed in the tax opinion.

defense to the penalty (pursuant to Code Section 6662 or 6664) based on reliance upon an opinion of counsel. The Preamble informs Treasury intends that an opinion may not be used for protection against Code Section 6662 penalties unless the opinion satisfies all the requirements of Proposed Section 10.35. Therefore, it seems Proposed Section 10.35 is *aimed* at opinions that the taxpayer intends (at the time the opinion is procured) to use -- if the tax shelter is successfully challenged by the Service -- to establish a "reasonable cause" defense to substantial understatement penalties.

The Problems with the Proposed Section 10.35 Tax Shelter Opinion Definition

The problem with the proposed "tax shelter opinion" definition is that it seems to encompass *any written advice* addressing any aspect of an actual or proposed tax shelter. For example, it would literally apply to any informal or preliminary written advice, including an e-mail note, a short message on a fax cover sheet or a two page memorandum responding to a single actual or hypothetical question. If our interpretation of this rule is accurate, a practitioner will not be able to provide any written advice on any aspect of any transaction that is or may become a tax shelter unless the practitioner issues a full-blown Section 10.35 opinion.

This raises significant problems for practitioners and clients in at least three different contexts. First, clients often seek advice on only one or two aspects of a larger transaction. For example, a client may want to know simply if a certain type of income is "subpart F income," if a certain item is deductible or subject to amortization, or if a certain item of income is US or foreign source. We believe clients should not be prevented from obtaining (without undue delay, cost or difficulty) advice on specific aspects of a larger transaction; and practitioners should not be subject to disciplinary sanctions because they provided the advice requested.

While it is true that Proposed Section 10.35 would apply only if the larger transaction is a Code Section 6662(d) tax shelter, the Section 6662(d) definition is extremely broad.[50] If Proposed Section 10.35 were adopted without modification, cautious practitioners who read the rule literally would suffer, while more aggressive practitioners and those who refused to read the rule literally would continue to provide advice on isolated issues. We recognize Treasury intends that advice on any aspect of a tax shelter not provide penalty protection unless the advice represents a full and complete consideration of all of the facts and all of the relevant law.[51] In other words, advice on isolated aspects of a larger tax shelter transaction should not, in Treasury's view, provide penalty protection. We do not disagree with this view, but we do think practitioners should be able to provide requested advice to clients (provided the clients are

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50 For example, many tax practitioners believe an acquisition structured to qualify as a tax-free reorganization under Code Section 368(a) would fit within the definition of a "tax shelter."

51 In fact, the current regulations under Sections 6662 and 6664 likely would make it impossible to use this type of isolated opinion to avoid penalties if the larger transaction is a Section 6662(d) tax shelter. *See* Regulations Sections 1.6662-4(g)(4)(ii) and 1.6664-4(c)((1) and (e)(2)(i)(B)(2). We expect that many practitioners and taxpayers have not focused on this aspect of the Section 6662 and 6664 rules and thus do not realize that an isolated opinion is unlikely to be of any assistance in avoiding penalties if the larger transaction fits within the very broad tax shelter definition. The proposal we refer to as the "Opt-Out Proposal" would, if followed, prevent those misconceptions.

aware the advice will not provide penalty protection).

The second context is that clients frequently ask practitioners questions during the preliminary, planning stages of a transaction. Practitioners respond by e-mail or with a short fax, an often preferable medium of response (as contrasted with an oral response), particularly if many people are involved in the structuring and planning or the people involved are located in different time zones. At that point, the facts of the transaction will be incomplete and unsettled and the practitioner will not know whether the final transaction (if there is one) will fit within the Section 6662(d) tax shelter definition. Even though the hypothetical or proposed transaction may never be consummated and, if it is, the preliminary advice likely will be superceded by subsequent, more formal and more complete advice, technically, the practitioner would have violated Proposed Section 10.35 unless all its requirements had been met.[52] We think it extremely unreasonable and illogical to require that all preliminary and informal advice during the planning stages be given orally, which is essentially what Proposed Section 10.35 would require if it were followed literally.

The third context is that a client may want a formal written opinion but not be interested in using the opinion for penalty protection purposes. This raises the question whether clients should be able to obtain (and 230 when the client does not intend to (and knows it cannot) use the opinion for Section 6662 or 6664 defense purposes. In those cases, obtaining an opinion that complies with Proposed Section 10.35 will be unduly expensive and time consuming and of no "value" to the client. We believe requiring these extensive requirements be met in all instances is an unwarranted intrusion into the lawyer/client relationship.

In each of these three contexts, the Proposed Rules make it more difficult for clients to obtain, and practitioners to provide, tax planning advice and thereby decrease, rather than increase, taxpayer awareness and voluntary compliance.

Proposed Solutions and Assessment of Their Advantages and Disadvantages

Before describing our proposed solutions, we make a few general statements and observations. First, we believe Section 10.35 should apply (and was intended by its drafters to apply) only to opinions that are intended to provide penalty protection--in other words, only when the client thinks the opinion will immunize it from substantial understatement penalties.

Second, we agree with Treasury and the Service that reliance on a tax shelter opinion should not protect a taxpayer against a Code Section 6662 substantial understatement penalty unless the opinion satisfies specified minimum standards, but we are not convinced those standards should be as onerous as the standards applicable to practitioners under Circular 230. While we agree more onerous standards likely would make it more difficult for a taxpayer to avoid a penalty on an overly aggressive tax shelter transaction (because it would be harder to obtain the requisite opinion), we are concerned imposing the suggested rules may have a far harsher impact on less sophisticated and knowledgeable taxpayers than on those taxpayers that

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[52] Compliance with Proposed Section 10.35 seems impossible in this scenario because the basic facts have not yet been determined.

are the most aggressive consumers of tax shelters.

Section 10.35 (at least, as proposed) will establish very specific standards that tax practitioners will be required to satisfy whenever they issue more likely than not or stronger tax shelters opinions. Tax practitioners will be responsible for familiarizing themselves with these rules and complying with them. Section 10.35 reflects Treasury's view of what a thorough and complete tax opinion should consider and address. Is it appropriate for these same high standards to be the threshold for a client to establish reasonable and good faith reliance on an opinion to establish a defense to Section 6662 penalties? To demonstrate, assume an opinion that complies with Section 10.35 is a "10" (on a scale of 1 to 10) in terms of thoroughness and completeness. A client receives and reasonably relies upon a tax shelter opinion that is an "8" in terms of thoroughness and completeness --the client's reliance is reasonable because the client does not know (or have reason to know) the opinion is an "8" and that a "10" is the minimum necessary.[53] In that case, even if the practitioner could be sanctioned under Circular 230, but should the client be barred from using the opinion to avoid penalties under Code Section 6662 if the client relied upon the opinion in good faith? If the problem is that taxpayers are trying to use opinions that they *know* are 8s to avoid penalties, is the most effective response to provide that no taxpayer may use an 8? Does not a rule like that result in a defense that will generally be available only to sophisticated taxpayers who know enough to demand opinions that are "10s"?

Our four proposed solutions are: [54]

Proposed Solution #1 --The Opt-In Statement:

> Section 10.35 applies only to written advice that includes an explicit statement to the effect that it is intended that, if the client's tax position is successfully challenged, the client may use the advice to attempt to establish a reasonable cause/good faith defense under Code Section 6662 or 6664. (If the Section 6662/6664 standards are the same as the Circular 230 standards, this Opt-In Statement rule would mean that an opinion could not be used to establish a Section 6662/6664 reasonable cause/good faith defense unless the opinion includes this statement.)

Proposed Solution #2 --Knows or Has Reason to Know:

> Section 10.35 applies to any written advice that the practitioner knows, or has reason to know, the client expects would provide penalty protection if the client's position were successfully challenged.

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[53] The opinion could be less than a "10" for any reason – for example, because the practitioner failed to address a specific contrary authority (well-known to tax practitioners, but unknown to the taxpayer client) or because the practitioner relied in part upon an opinion of a second practitioner and failed to fully describe the second practitioner's opinion.

[54] The requirement that the underlying transaction be a Code Section 6662(d) tax shelter is assumed in each proposal.

Proposed Solution #3 --The Opt-Out Statement:

> Section 10.35 applies to any written advice, unless the advice includes an explicit statement that it is not intended to be used for penalty protection purposes.

Proposed Solution #4 --The Dollar Threshold:

> Section 10.35 applies only if the tax shelter is expected to result in a prescribed minimum amount of tax savings, along the lines of what is provided for in the Section 6011 corporate taxpayer disclosure regulations.

Evaluation of the Four Proposed Solutions:

Proposal #1 --The Opt-In Statement:

The disadvantages of this proposal are:

(1) It is unfair to an unknowledgeable client if the practitioner leaves out the statement, with the result the opinion gives the client no penalty protection. (This analysis assumes that the Code Section 6662 and 6664 standards will conform to the Circular 230 standards, without any modifications.).

(2) Prohibiting a taxpayer from using actual good faith reliance on a opinion to avoid penalties *simply because* the opinion does not include the magic sentence also seems to conflict with the policy behind the Code Sections 6662 and 6664 reasonable cause and good faith defenses to tax shelter understatements. Sophisticated taxpayers would insist the statement be included and thus would not be negatively affected. Less knowledgeable taxpayers, not aware of this arcane requirement, would suffer if the practitioner (intentionally or out of lack of knowledge) failed to include the statement. The reasonable cause and good faith defenses to Section 6662 penalties seem to have been designed, at least in part, to afford some protection to this type of unaware taxpayer. While investors in tax shelters may not, as a class, be sympathetic objects, we believe the penalty rules should not apply more harshly to unsophisticated taxpayers than to sophisticated ones. [55]

(3) The opt-in statement allows a practitioner (or an informed client) to essentially "elect" whether Section 10.35 applies or not and thereby does not prevent practitioners from issuing more likely than not opinions on tax shelters that are not up to Section 10.35 standards. We believe this result would be fine where the client does not want or expect penalty protection, but would be problematic overall because unknowing taxpayers could be left unprotected. We believe this

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55 We recognize our suggestion (made in prior reports) that the reasonable cause and good faith exceptions to penalties for tax shelters be eliminated entirely would provide no protection for unsophisticated tax shelter investors, it would nevertheless apply evenhandedly to all tax shelter investors.

diverse treatment would conflict with the policies that produced the reasonable cause and good faith defenses in Sections 6662 and 6664, as well as the Circular 230 goal of protecting unknowledgeable taxpayers.

(4) The opt-in statement could prejudice the client by suggesting the practitioner and/or the client believe the underlying transaction is a tax shelter, the proposed tax treatment will be successfully challenged and penalties may be imposed. The response to this concern is that the opt-in statement, if adopted, would become a pro forma part of every formal opinion and would, in reality, carry no stigma.[56]

The advantages of the opt-in statement proposal are:

(1) It would be absolutely clear when Section 10.35 applies.

(2) The proposal would not interfere with providing answers to single issues, preliminary advice or formal non-penalty advice. [57]

(3) The statement may function as an additional warning to the taxpayer/client , deterring the taxpayer from entering into an overly aggressive transaction.

Proposal #2 --Know or Has Reason to Know:

The disadvantages of this proposal are:

(1) The practitioner and Treasury would face significant practical and administrative problems in trying to establish what the practitioner "knew or had reason to know." This would seriously complicate any Circular 230 proceeding.

(2) Practitioners would have no clear guidance as to when Section 10.35 applies.[58]

The advantages of the know or has reason to know proposal are:

(1) This rule would (in theory) limit Section 10.35 to opinions that are intended by the client to provide penalty protection, the intended scope of Section 10.35.

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[56] For what it is worth, the Code Section 6662 and 6664 regulations and Circular 230 could also explicitly provide that the statement will not be construed as implying anything and will have no effect on the determination of whether the taxpayer reasonably relied upon the opinion.

[57] We recognize that Treasury and the Service may believe that all more likely than not tax shelter opinions should be subject to Section 10.35, regardless of how the taxpayer intends to use the opinion.

[58] If the answer to these problems is to clarify what the practitioner and the client intend by stating it directly in the opinion, then we have returned to the opt-in and opt-out proposals.

Proposal #3 --The Opt-Out Statement:

The disadvantages of the opt-out statement are:

(1) Although it would be awkward to include the opt-out statement in every writing no matter how casual or short, we believe this statement would soon become a pro forma tag line to all written advice, other than advice intended to satisfy the reasonable cause and good faith exception standards.

The advantages of the opt-out statement are:

(1) This proposal permits the most flexibility in the practitioner/client relationship.

(2) This proposal will increase a client's understanding of the limits of the role of written advice in providing penalty protection and keep the risk of penalties clearly in view, which should further the goals of client protection and tax avoidance deterrence.

(3) It will be entirely clear when Section 10.35 applies.

(4) Clients will have the ability to determine whether each piece of written advice is written to comply with Section 10.35 and is thereby a potential source of penalty protection. The proposal avoids the opt-in statement problem of unsophisticated clients being at the practitioner's mercy.

Proposal #4 --The Dollar Threshold Proposal:

The disadvantages of this proposal are:

(1) It limits Circular 230 to opinions on large transactions and thus will have a disparate impact on practitioners providing tax shelter advice depending solely upon the size of the transactions.

(2) It will not necessarily be clear when Section 10.35 applies and will create another significant issue to be addressed in each case (initially by the client and the practitioner)[59] and subsequently by Treasury in enforcing Circular 230.

We do not see any significant advantages to this proposal, particularly if Treasury and the Service seek to prevent tax shelter abuses of all sizes.

Thus, while none of the four proposals is ideal, overall we believe the opt-out statement is the most workable and fair solution and would have the added benefit of increasing taxpayer awareness of the risks involved in overly aggressive transactions.

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[59] Although arguably, if client is a corporation, the issue may already have to be addressed (albeit, in a different forum) in determining whether Code Section 6011 disclosure and Section 6662 penalties apply.

Applying Section 10.35 To Marketing Opinions: Can and Should an Opinion that is Not Issued to the Taxpayer Provide Code Section 6662 Penalty Protection and Should That Opinion Be Subject to Section 10.35?

If we correctly discern Section 10.35 is intended to apply only to penalty-protection opinions, its application raises some interesting questions concerning more likely than not (and stronger) marketing tax shelters opinions. Specifically, may a taxpayer establish a reasonable cause and good faith defense under Code Section 6662 or 6664 based upon his or its reliance on a tax opinion issued to the promoter (rather than the taxpayer) or set forth in an offering document? And, if the answer is no, should those "non-reliance" opinions be subject to Section 10.35?

Some of our members believe reliance on a tax opinion should never establish a reasonable cause and good faith defense if the opinion was not issued *directly* to the reliant taxpayer. Other members believe an opinion should be able to be used for this purpose even if not addressed to the relying taxpayer directly, provided the opinion addresses the *specific* transaction or investment to which the taxpayer is a party. Thus, a tax opinion addressing a specific tax shelter transaction and set forth in the document offering interests in that specific tax shelter transaction or issued to the promoter and shown by the promoter to purchasers of an interest in that specific tax shelter transaction would be able to provide penalty protection to each purchaser (provided the other requirements of Code Section 6662 or 6664 are met), even though the opinion is not addressed to the specific purchaser taxpayer. For example, suppose a tax shelter takes the form of a trust and several purchasers buy interests in the trust. The promoter pays a law firm to issue an opinion to the promoter describing the tax consequences of purchasing, owning and selling an interest in that specific trust, the opinion reaches a more likely than not conclusion and the promoter provides this opinion to purchasers. In these members' views, each purchaser should be able to use this opinion to establish a reasonable cause and good faith defense to penalties.

It is not entirely clear if the current regulations under Code Sections 6662 and 6664 would countenance this result because those regulations require, among other things, that the tax opinion

> be based upon all pertinent facts and circumstances .... For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, ... the taxpayer [may not fail]to disclose a fact that it knows, or should know, to be relevant to the proper tax treatment of an item. [60]

Proposed Section 10.35(a)(3) contains a substantially identical requirement --requiring the opinion take into account *the taxpayer's* tax and non-tax purposes (and their relative weight) for entering into and for structuring a transaction in a particular manner. Proposed Section 10.33(a)(3) modifies this requirement by substituting "the typical investor's" for "the taxpayer's." Read

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[60] Regulations Section 1.6664-2(c)(1)(ii) and (3)(2)(i)(B)(2).

literally, these rules reveal that a more likely than not marketing opinion could never satisfy Proposed Section 10.35 (because the practitioner could never take into account the specific taxpayer's purposes) and thus any practitioner issuing an opinion would be subject to disciplinary action.

Perhaps this was a drafting error – and "or, in the case of a marketing opinion, the typical investor's tax and non-tax purposes" should be added to Section 10.35(a)(3). Or, perhaps this formal action reflects Treasury's view that a more likely than not level of assurance can *never* be reached on a tax shelter item without taking into account the taxpayer's specific situation and motives.[61] In either case, we think it extremely important that Circular 230 and the Code Section 6662 and 6664 regulations explicitly state whether a more likely than not marketing opinion will be subject to Section 10.35 and may be the basis for a reasonable cause and good faith/reliance on a tax opinion defense to Code Section 6662 penalties – and, in each case, whether the answer depends upon whether the marketing opinion is a generic opinion addressing a hypothetical transaction[62] or is specifically addressed to an actual transaction in which the taxpayers who were given the opinion invested.

In addition to clarifying when, if ever, a marketing opinion may provide penalty protection, we recommend Section 10.35 include a requirement like that in Proposed Section 10.33(a)(5)(iii), requiring that a Section 10.33 marketing opinion "clearly and prominently disclose on the first page of the opinion that the opinion was not written for the purposes of establishing" a reasonable reliance or reasonable cause and good faith defense under Code Section 6662(d)(2)(C)(i)(II)or 6664(c)(1). We propose Section 10.35 require this warning be added to any Section 10.35 opinion that will not qualify as the basis for a reasonable cause/good faith defense because it is a marketing opinion (*i.e.*, because it is not addressed to the specific taxpayer's situation). We also propose this warning be modified slightly by adding, at the end of the lead-in language (and before clause (A)), "and that reliance on this opinion may not be used to establish." [63] We also recommend that Section 10.35 require that any marketing opinion also state on its first page that whether the conclusions reached in the opinion will apply to any specific taxpayer will depend upon the facts and circumstances of the specific taxpayer. [64]

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61 The drafting error explanation seems more likely because the subsequent section of Circular 230, Proposed Section 10.35(a)(4), refers to "potential investors" and "a typical investor" and because the definition of "tax shelter opinion" in Proposed Section 10.35(c)(4) includes marketing opinions.

62 We believe reliance on a "generic" opinion – *i.e.*, an opinion that address a generic transaction structure and may, or may not, be based upon generic "model" documents should never provide penalty protection. It is not clear, however, if a generic marketing opinion that reaches a more likely than not conclusion would be subject to Section 10.35.

63 Thus, the section would begin: "The opinion must clearly and prominently disclose on the first page of the opinion that the opinion was not written for the purpose of establishing and reliance on the opinion may not be used to establish — (A) Under section ...." We also recommend that this same modification be made to Proposed Section 10.33(a)(5)(iii).

64 This warning should also be required on the first page of a Section 10.33 opinion.

Warning to Taxpayers Regarding Circular 230 Requirements

If an opinion must comply with Section 10.35 to provide a taxpayer with a reasonable cause/good faith defense, we believe a Section 10.35 opinion should be required to state that. In other words, a Section 10.35 opinion should be required to include either the Proposed Section 10.33(a)(5)(iii) warning referenced to in the prior section or the following warnings:

(1) Treasury Regulations provide that an opinion must satisfy the requirements of Circular 230 to be used as part of a reasonable belief/good-faith and reasonable cause defense under Code Section 6662 or 6664; and

(2) satisfaction of the Circular 230 requirements will not insure the success of the reasonable belief/good-faith and reasonable cause defense.

These disclosures should have to be included in the opinion because, without these disclosures, the advice is incomplete. One of the primary themes of Section 10.35 is to insure that clients receive advice, in writing, on each aspect of the tax consequences of the transaction that may be material to them. That the tax opinion will not assist the client in avoiding substantial understatement penalties unless it complies with Circular 230 is crucial information to the taxpayer. The taxpayer should also, however, be warned that compliance with Circular 230 does not insure success. In addition, requiring these matters be disclosed should improve Circular 230 compliance because taxpayers will want to be sure that the opinions they receive satisfy the penalty protection standards.[65] On the other hand, we do not believe a client should be disadvantaged because the practitioner fails to make this disclosure. Accordingly, the amendments to the Code Section 6662 and 6664 regulations that will provide an opinion must satisfy Section 10.35 to be used as part of a reasonable cause/good faith defense, should clarify that the failure of the opinion to comply with this disclosure requirement will not be taken into account.[66]

B. Scope of Proposed Section 10.33 --What makes an opinion a "marketing opinion".

RECOMMENDATION: Clarify (1) that Section 10.33 does not apply where a practitioner does not know or have reason to believe (after adequate inquiry) that practitioner's review of the offering materials will be referred to in the marketing of the transaction, (2) what the practitioner's obligations are with respect to insuring that any opinion that is covered by Section 10.33 is described accurately and completely in the marketing of the transaction and how those obligations may be satisfied, (3) what practitioner's obligations are if the practitioner's firm is referred to in the offering materials because it provided non-tax advice on the transaction and, (4) practitioner's obligations if he or she learns after marketing has been completed that his or her tax advice was misrepresented. Also, Section 10.33 should cover opinions used for marketing, even where

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65 Although certain practitioners may violate this requirement, overall it will increase taxpayer awareness of this new rule and thus make it more fair to prohibit a taxpayer from using an opinion for penalty protection purposes on the grounds it does not comply with Section 10.35.

66 More generally, we believe it would be appropriate for those amendments to provide that, in determining whether an opinion satisfies the Section 10.35 standards, divergences that are not material to the substantive analysis of conclusions generally will be disregarded.

marketing is done by the person who issued the opinion or a member of the same firm.

Marketing Opinions Used in Marketing by the Authoring Tax Practitioner or Someone in the Same Firm as the Author

Proposed Section 10.33 applies to written advice only if the

> "practitioner knows or has reason to believe [the written advice] will be used or referred to by a person other than the practitioner (or person who is a member of, associated with, or employed by the practitioner's firm or company) in promoting, marketing or recommending the tax shelter to one or more taxpayers ...." [67]

Apparently, therefore, an opinion used in marketing is not subject to Proposed Section 10.33 (and, unless it is a "more likely than not" opinion, also is not subject to Proposed Section 10.35) if the marketing is performed by the practitioner or by someone in the same firm as the tax practitioner. This is illustrated in Example 2 in Proposed Section 10.33(a)(6): a practitioner writes a memorandum evaluating the tax consequences to a hypothetical taxpayer of a tax shelter transaction designed to create capital losses. The memorandum concludes there is a realistic possibility that the proposed tax treatment is proper (so Proposed Section 10.35 does not apply). The practitioner intends to provide the memorandum directly to clients with capital gains. The example concludes the "memorandum is not a tax shelter opinion for purposes of [Proposed Section 10.33] because the promoting, marketing or recommending of the tax shelter is not being done by a person other than the practitioner."

In other words, a practitioner is subject to discipline under Circular 230 for issuing a marketing opinion that does not lay out all the caveats, address all the relevant facts and issues and clearly state a conclusion as required by Section 10.33 *if* the opinion is used by a third party to market the investment; but, the practitioner is not subject to discipline if the practitioner, or the practitioner's partner or another employee who works for the same law firm, accounting firm or investment bank, uses the opinion to market the investment. We believe that result improper and in defensible.

We believe this anomaly results from the fact that when Section 10.33 was initially added to Circular 230, one of the primary concerns was that the practitioner who authored the opinion was hired by and had primary allegiance to the promoter, not the taxpayers that were the subject of the advice. Section 10.33 was designed to insure the practitioner provided the taxpayers (with whom the practitioner did not have an attorney/client or accountant/client relationship) *all* the relevant information. Underlying this is, of course, the assumption that where the taxpayer and the practitioner have a one-on-one relationship, there is no need to prescribe standards of information dissemination.

Whether or not we are correct about the history, we see no justification for continuing this distinction. The reality of today's marketplace is that tax shelter promotion is performed by law

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[67] Proposed Section 10.33(c)(4).

firms, accounting firms, investment managers, investment banks and other persons providing financial services and advice and many times the tax opinion included in the offering materials is prepared in-house. In some cases, the tax opinion author may be involved directly in the marketing, while in others the author may be as removed from the marketing as he or she would be if employed by an entirely different company or firm.

Proposed Section 10.33 appears to be aimed primarily at protecting potential investors who might mistakenly interpret a generic tax memorandum or a tax discussion included in the offering materials to mean the investment "works," without realizing the full extent of the risks and uncertainties involved, that the advice will not protect them from penalties and that the advice does not address their specific individual situation. Why should this protection be limited to investors who are approached by a promoter who has obtained the tax advice from a third-party law or accounting firm and not cover investors who are approached by a promoter who obtained the tax advice from a partner or a co-employee, or who *authored* the tax advice?[68]

In addition, it seems to us that Section 10.33 has a distinct and important goal that, under current law, may be difficult to achieve in other ways. Section 10.33 limits the use of incomplete or poorly reasoned tax advice to market tax shelter investments. Because these opinions do not purport to provide penalty protection, standards established under Code Sections 6662 and 6664 do not apply.[69] Section 10.33 should not be limited to marketing opinions issued to the promoter and exclude opinions issued by the promoter or someone affiliated with or employed by the same company or firm as the promoter.

Section 10.33 Should Not Apply Unless the Practitioner Knows or Has Reason to Know the Opinion Will Be Used in Marketing

In a different respect, we think the definition of a "tax shelter opinion" subject to Proposed Section 10.33 too broad. Specifically, following the general definition quoted above, the definition continues by providing that a tax shelter opinion

> (1) includes "the Federal tax aspect or tax risks portion of offering materials prepared for the person who is promoting, marketing or recommending the tax shelter by or at the direction of the practitioner, whether or not a separate opinion letter is issued or whether or not the practitioner's name is referred to in the offering materials or in connection with the sales efforts," and (2) does not include advice in reviewing offering materials "provided neither the name of the practitioner or the practitioner's firm, nor the fact that *a* practitioner has rendered advice concerning the Federal tax aspects is referred to in the offering materials

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68 Even where there is a direct practitioner/client relationship between the practitioner and the ultimate taxpayer that does not lessen the need for Circular 230 compliance. If it did, why would there be any need for Section 10.35?

69 We recognize that in some cases it may be argued that Section 6694 applies to the practitioner.

or the related sales promotion efforts." [70]

Thus, under the general rule, "written advice" is covered by Proposed Section 10.33 only if the practitioner "knows or has reason to believe" it will be used to market the tax shelter. Similarly, if the practitioner prepares the tax section to be used in marketing materials, that tax section is subject to Proposed Section 10.33. If the practitioner merely reviews the marketing materials tax section, Proposed Section 10.33 does not apply, *provided that* neither the offering materials nor the individual marketers refer to the practitioner or the practitioner's firm by name or state that *any* practitioner has provided tax advice.

The problem is that the proviso is absolute – in other words, if the practitioner's name is mentioned (whether in writing or orally), the reviewed tax section becomes subject to Proposed Section 10.33, even if the practitioner did not authorize or anticipate the use of her name. The practitioner will be subjected to the standards of Proposed Section 10.33 if a single marketer tells a single potential investor the tax advice has been reviewed by a practitioner.

We believe these rules are both unfair and counterproductive. First, how can a practitioner know if the promoter or its marketing personnel will refer by name to the practitioner's firm or claim the tax practitioner has authored or reviewed the tax section? Section 10.33 should apply to "advice in reviewing" only if the practitioner knows or has reason to know the promoter or marketing personnel will inform investors the tax section has been approved by or is based upon advice provided by the tax practitioner.

Second, read literally, these rules render the practitioner who reviewed the offering materials fully responsible for their content, even in cases where the practitioner advised the promoter the disclosure was incomplete or inaccurate. Because Proposed Section 10.33 makes each practitioner who reviews the tax section fully responsible for it, no practitioner should be willing to subject herself to sanction by reviewing offering materials prepared by someone else. It is not uncommon for a second law firm to become involved some time during the process – the second firm may represent the underwriter, or a third party that will act as trustee, administrator or manager, or the second firm may be hired by the promoter to take a "second look." Circular 230 should not discourage additional practitioners from reviewing and commenting on certain aspects of the offering materials.

Frequently, a supplemental tax review will be conducted at the request of the securities or corporate lawyers. A promoter may turn to one firm for a tax opinion and a second firm for securities and corporate advice. The securities and corporate lawyers may ask one of their tax partners to review the materials to insure that things are in order. The name of the securities/corporate firm will appear in the marketing materials as a result of the firm having handled the securities and non-tax work – it appears that the tax lawyers in the securities firm who reviewed the materials (whether or not they made any comments or suggestions to the drafters of the tax section) are then subject to discipline pursuant to Section 10.33. This level of involvement does not seem sufficient to subject the reviewing tax practitioners to Section 10.33 standards. More importantly, this kind of supplemental review is not something that should be

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[70] Proposed Section 10.33(c)(4) (emphasis added).

discouraged by the Government.

We propose these concerns be addressed by providing in Section 10.33 that:

(1) if a practitioner provides written advice or prepares a portion of the marketing materials, Section 10.33 should be applied to the written advice or portion of the offering materials prepared by the practitioner in the form in which it is given, provided that the practitioner takes reasonable steps to insure that the advice is reflected or referred to in the marketing materials fully, fairly and correctly; and

(2) a practitioner will not be subject to Section 10.33 as a result of merely reviewing marketing materials prepared by someone else, provided the practitioner takes reasonable steps to insure that the fact that the practitioner reviewed the discussion is not reflected or referred to in the marketing.

Section 10.33 should include examples illustrating the "reasonable steps" for these two purposes. We propose the following:

(1) if the client is a new client, the practitioner should require the client to sign an agreement specifying the advice to be given by the practitioner will be reflected and referred to in the marketing materials only in a manner approved in advance by the practitioner and that all marketing materials will be subject to review by the practitioner before they are given to potential customers or used in oral presentations;

(2) if the client is an ongoing client of the practitioner – there is an established relationship a written agreement generally would not be required; instead, it would be sufficient if the practitioner obtains oral assurances from the client that the practitioner will have the right to review and sign-off on all marketing materials before they are disseminated or used in marketing;

(3) if, for any reason, the practitioner suspects or reasonably should suspect that the tax advice will be misrepresented in the marketing or that the practitioner's name may be used in connection with the marketing, the practitioner must take additional steps, such as discussing the practitioner's concerns with the client and obtaining further assurances, asking to speak directly to the marketing personnel, asking to see a dry-run of the "road show" presentation or attending a "road show" presentation; and

(4) if the practitioner suspects the tax advice has been misrepresented, the practitioner must call it to the client's attention, request the client take steps to correct the error in the future and to advise any potential customers who may have been misled; the practitioner should write a letter to the client documenting the matter and, if the practitioner is not satisfied that the problem has been solved, the practitioner should notify the client in writing that the client is no longer authorized to use the practitioner's tax advice in connection with the tax shelter.

C. Substantive analysis of tax issues and tax items

Proposed Sections 10.33(a)(3) through (a)(5) and 10.35(a)(3) through (a)(5) provide the rules regarding the substance of the tax analysis that must be included in tax shelter opinions. These sections distinguish between "tax issues" and "tax items" and how they must be addressed in an opinion:

(1) Proposed Sections 10.33(a)(3) and 10.35(a)(3) provide that all *material Federal tax issues* must be addressed;

(2) Proposed Sections 10.33(a)(4) and 10.35(a)(4)(i) provide that a conclusion must be stated as to the likelihood the taxpayer will prevail on the merits with respect to each *material Federal tax issue that involves a reasonable possibility of challenge*; and

(3) Proposed Sections 10.33(a)(5)and 10.35(a)(4)(ii) provide that a conclusion must be stated as to whether the tax treatment of the *tax shelter items* is proper.

The Proposed Regulations define a "tax issue" as "[a]ny Federal tax issue the resolution of which could have a significant impact (whether beneficial or adverse) on a taxpayer under any reasonably foreseeable circumstance;"[71] and a "tax shelter item" as "[a]ny item of income, gain, loss, deduction or credit if the item is directly or indirectly attributable to a tax shelter." [72]

These provisions raise several questions:

1. What is the difference between a tax issue and a tax shelter item?

2. What is the purpose of requiring one type of conclusion --likelihood of prevailing on the merits – as to issues and another type of conclusion – whether the tax treatment is proper – as to items?

3. If the treatment of an item depends upon the analysis of the issues, can a practitioner reach a stronger conclusion as to the item than he or she reached as to the underlying issues? In other words, can a practitioner determine the treatment of the item is more likely than not proper without determining that the analysis of each of the issues is more likely than not proper?

4. Which tax attributes are covered by the term "item"? Does an item encompass each tax attribute that may apply to income or loss, such as the amount, timing, source, character, foreign tax credit basket etc. For example, is the question of whether an item of income is of a U. S. or foreign source, or general limitation or passive basket, a tax issue or a tax item?

5. Finally, if a practitioner has reached a more likely than not conclusion as to one

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71 Proposed Sections 10.33(c)(5) and 10.35(c)(5).

72 Proposed Sections 10.33(c)(3) and 10.35(c)(3).

aspect of an item (*e.g.*, that the item is currently deductible), but has reached a weaker conclusion as to another aspect of the item (*e.g.*, whether it is a U. S. or foreign source deduction), would Proposed Section 10.35 apply?[73] Would a practitioner have violated Circular 230?[74] Is a practitioner simply barred from being able to issue such an opinion, without facing disciplinary action?

An example should help illustrate these points. Assume the tax shelter involves a taxpayer issuing a financial instrument intended to create interest deductions. The questions presented include the following:

> is the instrument debt for tax purposes? does the instrument constitute a constructive sale of an asset held by the issuer? are the interest and original issue discount accruals determined under Treasury Regulations section 1.1275-4? what is the proper issue price and proper number of years to maturity for determining the original issue discount accruals? are the interest deductions disallowed under Code Section 263(g) or 163(j)?

In this scenario, which questions are the issues and which are the items?

Are the questions of "what is the issue price" and "what are the number of years to maturity" "issues" while the resulting interest deduction is an "item"? If that is the case, the opinion would be required to address only whether the determination of the issue price and term were likely to be upheld on the merits, but would be required to conclude that the interest deduction is more likely than not proper.

A conclusion that something is more likely than not proper seems to be a stronger conclusion than a determination that more likely than not will prevail on the merits. Could a practitioner reach a conclusion that the treatment of the interest deduction is more likely than not proper while being less certain that the issue price has been determined correctly or that the instrument is indeed debt? Section 10.35(a)(4)(ii) states simply that a conclusion that the tax treatment of the tax shelter items is more likely than not (or higher) the proper tax treatment may not be based solely on the conclusion that the taxpayer more likely than not will prevail on the merits as to each material Federal tax issue.[75]

We believe this confusion stems, in part, from ABA Opinion Number 346, which was used as a model for Circular 230. That opinion requires, generally, that all material tax issues be addressed and then that the opinion state a firm conclusion, but does not distinguish between issues and items.

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[73] Proposed Section 10.35(a) states that the section applies to any tax shelter opinion that concludes the Federal tax treatment of a tax shelter item or items is more likely than not (or higher) the proper treatment.

[74] Proposed Section 10.35(a)(4)(ii) requires that the opinion unambiguously conclude the Federal tax treatment of the tax shelter item or items is more likely than not (or higher) the proper treatment.

[75] Mathematically, the principle is unavailable: .51 x .51 x .51 does not exceed 50 percent. Actually, it is less than 15 percent.

Questions 4. and 5. above indicate how the rules are unclear when an item of income or deduction has several attributes.

We suggest these matters be clarified by making the following modifications;

1. Modify the definition of a tax shelter item as follows:

> a tax shelter item is any attribute of any item of income, gain, loss, deduction or credit that could affect the tax liability of a taxpayer, including the amount, timing, source, character, foreign tax credit basket and whether it constitutes "Subpart F" income.

2. Modify the definition of a material Federal tax issue as follows:

> a material Federal tax issue is any question the resolution of which could have any affect on any aspect of a tax shelter item.

3. Clarify whether a more likely than not conclusion can be reached as to a tax shelter item if the opinion does not reach a more likely than not (or stronger) conclusion as to each underlying issue.

4. Provide that a tax opinion that provides a more likely than not (or higher) conclusion as to any tax shelter item is subject to Section 10.35, even though it may not reach a more likely than not (or higher) conclusion as to other tax shelter items.

5. Clarify whether an opinion subject to Section 10.33 or 10.35 must address all the aspects of all the tax shelter items of the taxpayer generated by the tax shelter. In other words, could the opinion conclude the foreign taxes are income taxes eligible for credit under Code Section 901 without opining as to the Section 901(d) foreign tax credit basket to which the income and taxes belong or when the taxes accrue for U. S. Federal income tax purposes?[76] It seems unfair and perhaps impractical to require a practitioner to address every possible tax aspect of an item of income, loss, deduction or credit that may be relevant, especially in a marketing opinion. On the other hand, one of the primary purposes of Proposed Sections 10.33 and 10.35 is to prevent practitioners from issuing opinions that address only "part of the story." A suggestion would be to require the practitioner to address all aspects of all tax shelter items the practitioner knows or reasonably should anticipate would be relevant to the taxpayer.

We also believe a Section 10.35 opinion that does not reach a more likely than not conclusion as to all the tax shelter items (*i.e.*, all attributes of all items of income, gain, loss, deduction or credit) addressed (or required to be addressed) should be required to state that fact in a statement similar to that required by Proposed Section 10.33(a)(5)(ii). Proposed Section 10.33(a)(5)(ii) requires a Section 10.33 opinion to clearly and prominently disclose on the first page of the opinion that the opinion does not reach a more likely than not conclusion (or does not reach any overall conclusion) as to the tax shelter item or items.

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[76] *Compare* Proposed Section 10.35(a)(4)(ii) with Proposed Section 10.33(a)(5)(ii).

D. Opinion should be required to address tax shelter regulations.

RECOMMENDATION: Both 10.33 and 10.35 opinions should be required to briefly describe the tax shelter disclosure, registration and list-keeping requirements under the Code Section 6011, 6111 and 6112 regulations and to discuss whether those requirements apply to the transaction, but should not be required to reach an overall conclusion.

As stated in our July 2000 Report, we believe a tax shelter opinion should address whether Section 6011 disclosure, Section 6111 registration or Section 6112 listing may be required with respect to the tax shelter.[77] We recognize requiring a practitioner to advise a client on procedural matters when the client is seeking advice only on the substantive treatment of the tax shelter may be viewed as an intrusion into the practitioner/client relationship. Nevertheless, we think requiring opinions to address disclosure and registration requirements would increase compliance with, and further the goals of, the disclosure, registration and listing regulations.

The primary goals of the these regulations are detection, deterrence and prevention. The regulations are designed to accomplish these goals by making it easier for the Service to learn of the existence and details of tax shelter transactions and who has entered into them, and to react by both publishing guidance in a timely fashion and challenging taxpayers' positions. If the new regulations and the new Office of Tax Shelter Analysis work as planned, both the odds of surviving the audit lottery and taxpayers' appetites for tax shelters will be greatly reduced.

Because Proposed Sections 10.33 and 10.35 have similar aims, we believe it appropriate to require the Section 6011, 6111 and 6112 regulations be addressed. For example, Proposed Sections 10.33 and 10.35 aim to protect, alert and deter taxpayers from entering into inappropriate tax shelter transactions (by requiring the practitioner to explain the real issues and weaknesses in the tax analysis and to clearly state the practitioner's actual assessment of the merits of the tax position after taking into account *all* the facts and *all* the law). Discussing the Section 6011, 6111 and 6112 regulations would further these purposes because taxpayers that read the opinions would see a more complete picture of the risks faced[78] and hopefully would be prompted either to disclose the transaction, or, where the position is without sufficient merit, to not complete the transaction.

Proposed Section 10.35 also aims to prevent the sophisticated taxpayer from avoiding Code Section 6662 understatement penalties by claiming that it reasonably and in good faith relied on an opinion that the taxpayer knew (or should have known) was incomplete or poorly reasoned (by discouraging tax practitioners from issuing those deficient opinions). The Section 6011 disclosure regulations also aim, indirectly, to make it more difficult for a taxpayer to inappropriately establish a reasonable reliance and good faith defense. The preamble to those regulations informs that a corporate taxpayer that fails to make the disclosure required by Temporary Regulations Section 1.6011-2T will be presumed to have *not* acted in good faith for Section 6664 purposes. Requiring a tax shelter opinion to address whether the disclosure rules apply (even without requiring that an

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77 *See* Temporary Regulations Sections 1.6011-4T, 301.6111-2T and 301.6112-1T.

78 Including the greater audit and change in law risks resulting from increased disclosure, registration and listing and increased Government enforcement efforts.

affirmative conclusion be reached) should reduce markedly the misuse of the reasonable reliance and good faith defense because the opinion itself would make it more difficult for a taxpayer to establish that it did not think Section 6011 disclosure was required (and, therefore, that the failure to disclose under Section 6011 should not affect the determination of whether the taxpayer acted in good faith for Section 6664 purposes).

We believe these benefits justify intruding into the practitioner/client relationship to require these procedural rules be addressed. We also believe Circular 230 to be the appropriate venue for this requirement because a tax practitioner has an ethical responsibility to address the issues that may materially impact the success of the taxpayer's position, including issues that increase the likelihood the transaction will be audited or that the relevant law will be changed (or clarified) in a manner adverse to the taxpayer.

While we recommend opinions subject to Sections 10.33 and 10.35 be required to address the Code Section 6011, 6111 and 6112 regulations, we do not, at this time, recommend the practitioner be required to state an overall conclusion as to whether disclosure, registration or listing is required. We do not think it fair or appropriate to require overall conclusions because there are, now, no guidelines or standards for Section 6011, 6111 and 6112 opinions. We think it would be problematic to apply the standards set forth in Proposed Sections 10.33(a)(3) through (a)(5) and 10.35(a)(3) and (a)(5) because the Section 6011, 6111 and 6112 regulations address different issues.

We do, however, urge the promulgation of specific guidelines and standards for opinions addressing the Section 6011, 6111 and 6112 regulations – both standards applicable to practitioners issuing opinions and requirements applicable to taxpayers (and promoters) seeking to rely on these opinions. We would be pleased to work with you in developing those guidelines.

E. Statement of facts.

RECOMMENDATIONS: A tax shelter opinion subject to Section 10.33 or 10.35 should be required to disclose and describe all relevant agreements and other documents reviewed by the practitioner.

Under Proposed Sections 10.33(a)(1)(i) and 10.35(a)(1)(i), the opinion (and any related offering or sales promotion materials) must accurately and completely describe all material facts (including any factual assumptions and representations). The practitioner also must inquire as to all relevant facts and be satisfied the opinion takes into account all the relevant facts.[79]

Tax shelter opinions also should be required to identify all the relevant agreements and other documents (such as corporate by-laws, board of directors resolutions or a five-year business plan) reviewed by the practitioner. The list of agreements and other documents could be in the opinion text or attached as an appendix. This requirement will encourage clients to provide all documents to the practitioner because, if the client fails to show the practitioner any significant document, that failure will call into question whether the client reasonably relied in good faith on

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[79] Proposed Sections 10.33(a)(1)(i) and 10.35(a)(l)(i).

the opinion for Code Section 6662 and 6664 purposes.[80] This requirement also will make it less likely a practitioner will miss, or try to avoid addressing, a material fact or tax issue not helpful to the desired opinion conclusion.[81] We do not believe this agreement listing requirement would be onerous. We believe many practitioners already follow this practice when issuing formal opinions.

We considered whether the document listing requirement might be problematic in the context of a Section 10.33 marketing opinion. For example, it could be argued that the list of documents would make the opinion or the tax section of the offering materials longer and denser and, therefore, make it less likely that potential investors will focus on the most important aspects of opinion. The list might also confuse potential investors who, although they understand generally how the transaction works and the risks they will face, do not understand the technical role of each separate agreement. We believe these concerns would be adequately addressed by allowing the list of agreements to be included in an appendix to the opinion (and to any offering or marketing materials describing the opinion).

F. No inconsistent analysis or conclusions with respect to Federal tax issues.

RECOMMENDATION: Clarify that an opinion may discuss alternative theories for one or more of its conclusions, provided that the requirements of Section 10.33 or 10.35 have been satisfied relying on one consistent theory.

Proposed Sections 10.33(a)(2)(iv) and 10.35(a)(2)(iv) provide: "The opinion must not contain legal analyses or conclusions with respect to Federal tax issues that are inconsistent with each other."

What is being prohibited here and why? We agree that a practitioner should not reach an overall conclusion as to a tax shelter item by relying on inconsistent legal analyses as to two different Federal tax issues. Provided the opinion reaches an overall conclusion as to all the tax shelter items by relying on one consistent theory, the practitioner should be able to discuss one or more alternative theories and provide support for them as well,[82] even if the practitioner is unable to reach the same level of assurance as to all the tax shelter items using the alternative theory or theories. It is well settled that a taxpayer may set forth alternative, inconsistent arguments in a pleading or a brief. We see no policy reason for denying a taxpayer access to a tax opinion that sets forth alternative arguments to bolster one or more aspects of the taxpayer's position.

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80 This principle could be stated in the Code Section 6662 and 6664 regulations, or those regulations could simply require that the opinion list all relevant documents as a condition to the taxpayer being able to establish that it reasonably relied on the opinion. This requirement would be similar to the existing requirement in those regulations that the opinion not rely on representations or assumptions the taxpayer knows are inaccurate.

81 For example, assume the client tells the practitioner that the business purpose of the tax shelter transaction is to invest in gold bullion, but the client has separately hedged its entire exposure to gold bullion prices. The document listing requirement would make it more difficult for the client and practitioner to ignore the hedge in analyzing the tax shelter.

82 If the practitioner fails to do so, the client might have a malpractice claim against the practitioner.

The regulations should be clarified to explicitly provide that, if the practitioner has reached a more likely than not conclusion under one theory (and the opinion is, therefore, subject to Section 10.35), the practitioner need not reach a more likely than not conclusion under each alternative theory.[83]

A practitioner should be prohibited, however, from issuing two entirely separate opinion letters as to one transaction if the opinion letters are inconsistent as to any material fact or the statement or application of any material aspect of U. S. Federal income tax law. For example, a practitioner should not be able to issue one opinion letter concluding an instrument is debt for U. S. Federal income tax purposes and another opinion letter concluding the same instrument is equity for U. S. Federal income tax purposes. A practitioner should, though, be permitted to issue a second opinion letter that is issued for a non-U. S. federal income tax purpose (*e. g.*, to present to a non-tax regulatory body or a local or foreign tax authority) that is tailored to that purpose. For example, a practitioner who has issued a detailed opinion that fully complies with Proposed Section 10.35 should be able to provide the client with a second opinion letter, reaching the same conclusions, but omitting the detailed analysis, for the client to use for foreign tax or regulatory purposes.

G. Alternative factual scenarios.

RECOMMENDATION: If relevant facts are uncertain and more than one factual scenario is reasonably possible, an opinion should be allowed to include analysis and conclusions as to each reasonable factual scenario.

When an opinion issues, some facts may be uncertain, such as how the transaction will be treated under local non-tax law or under foreign tax law or whether a party to the transaction will exercise an option that becomes exercisable in the future. It is not clear how Proposed Sections 10.33 and 10.35 apply to these "uncertain" cases. Proposed Sections 10.33 and 10.35 require the practitioner be satisfied that the opinion has taken into account all relevant facts and prohibit the practitioner from issuing an opinion based upon any unreasonable factual assumptions.[84]

Where more than one factual scenario is reasonably possible, should Sections 10.33 and/or 10.35 require that all reasonably possible factual scenarios be analyzed? Depending upon the situation and how broadly "reasonably possible" is defined, that requirement could be impractical and unfair to both practitioners and clients. Where some facts are uncertain, Circular 230 should not *require* the opinion to address more than one reasonable scenario, but should *permit* the opinion to do so.

May an opinion addressing alternative factual scenarios reach different conclusions as to each factual scenario? For example, could an opinion conclude that an item of income is more

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[83] This issue is similar to the issue addressed above as to whether an opinion that reaches a more likely than not conclusion as to one tax shelter item must reach that same level of assurance with respect to a second tax shelter item.

[84] Proposed Sections 10.33(a)(l)(i) and (ii) and 10.35(a)(l)(i) and (ii).

likely than not foreign source based upon representations as to how the tax shelter will operate, but also state that the source of the income would be less clear (or that the income will be U. S. source) if the tax shelter were to fail to operate as expected? Could discussion of an alternative factual scenario include a legal theory that is inconsistent with the primary theory?

We believe a practitioner addressing different factual scenarios should be entitled to reach different conclusions (including conclusions of a different strength) under alternative factual scenario(s).[85] The opinion also should be permitted to apply an inconsistent legal theory (or theories) when analyzing an alternative factual scenario, but only if all the factual scenarios that are addressed are analyzed (and a conclusion is reached) under at least one consistent legal theory. This requirement is intended to protect taxpayers by insuring that they understand all the risks involved. In no event should a practitioner be permitted to issue two entirely separate opinion letters based upon two different sets of assumptions and/or representations about future events. In other words, all factual scenarios that a practitioner addresses must be addressed in one opinion.[86]

H. Reliance on Opinions of Others – Clarification Needed.

The rules permitting a practitioner to rely, in part, upon an opinion of another practitioner are unacceptably unclear. We refer you to pages 6 and 7 of the attached chart for a specific description of these sections and a comparison of the rules applicable under Proposed Sections 10.33 and 10.35. These rules seem to permit one practitioner (the "generalist") to rely on another practitioner (the "specialist") under certain circumstances and in certain ways. Yet, exactly how these rules work is not clear. Our questions and concerns are:

1. While the Proposed Section 10.33 rules appear to apply to both the "generalist" and the "specialist,"[87] the Proposed Section 10.35 rules appear to apply only to the generalist.[88]

2. Is the generalist required to issue an opinion on *all* the issues and *all* the items, but in doing so may rely on the specialist as to some matters, or may the generalist address only a portion of the Federal tax issues and leave the remainder to the specialist? For example, assume there are 10 issues, all relating to one item. May the generalist address issues 1 through 8 and leave 9 through 10 to the specialist (this appears to be what is contemplated under Proposed Section 10.33(b)(1)(i)(A)),

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85 In other words, an opinion could reach a more likely than not conclusion as to a tax shelter item under one set of facts, and a less than more likely than not conclusion as to that same item under another set of posited facts. This issue is similar to the issues raised above as to whether a more likely than not opinion may reach a weaker conclusion as to some tax shelter items or as to the same items when applying an alternative legal theory.

86 We recognize a taxpayer with sufficient resources could circumvent this restriction and obtain two separate opinion letters addressing alternative factual scenarios by simply engaging two different practitioners. We see no way to prevent this form of opinion shopping.

87 *See* Proposed Section 10.033(b)(l)(ii).

88 *See* Proposed Sections 10.35(b)(1)-(3).

or must the generalist address issues 1 through 10, but in doing so rely upon the specialist's views as to issues 9 and 10 (which appears to be what is contemplated under Proposed Section 10.35(b))?

3. Can specialist's opinion address specific issues without addressing any of the related items? May the generalist's opinion incorporate the specialist's conclusions as to the issues in reaching the generalist's overall conclusion as to the items without judging the efficacy of the specialist's opinion?

4. Under Proposed Section 10.35, the practitioner[89] must be satisfied that both opinions together satisfy Proposed Section 10.35, whereas under Proposed Section 10.33, the practitioner must be satisfied that his or her own opinion satisfies Proposed Section 10.33 and not have any reason to believe the other opinion does not satisfy Proposed Section 10.33.

5. Under Proposed Section 10.35, the opinion – presumably the generalist's opinion – must clearly identify the other practitioner – *i.e.*, the specialist, state the date on which the other opinion was rendered and the conclusions reached in that opinion, whereas there are no similar requirements under Proposed Section 10.33.

6. Under Proposed Section 10.35, a prerequisite to relying upon an opinion of another practitioner is that the first practitioner is "not sufficiently knowledgeable" to render an opinion with respect to a particular issue; it is not clear what this means nor is it clear why there is no similar condition under Proposed Section 10.33.

We suggest that these uncertainties be clarified and resolved as follows. (The numbering used below corresponds to the numbering used above.)

1. Clarify that the rules of Sections 10.33 and 10.35 apply to any practitioner issuing any opinion on any aspect of a tax shelter. If one of the opinions would be covered by Section 10.35 because it reaches a more likely than not or higher conclusion as to any tax shelter item – both should be subject to Section 10.35.

2. Clarify that neither opinion is required to address all the issues or all the items, but together the opinions must address all the issues and all the items.

3. A specialist should be able to opine on certain issues, without addressing the related items; in that case, the generalist would then be relying upon the specialist's conclusions as to those issues opined upon by the specialist in reaching the generalist's conclusion as to the items. For example, assume the item involved is an interest deduction and the issues involved include whether the instrument is debt or equity, what the issue price of the instrument is and how long is its term. A specialist could be relied upon for the debt/equity determination, and a generalist could incorporate that analysis into an opinion in which the generalist analyzes the

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89 As stated above, this appears to refer only to the generalist.

other issues and reaches an overall conclusion.

If both opinions are subject to Section 10.33 or 10.35, there should not be any concern about circumventing Circular 230 by using multiple practitioners to reach an overall conclusion as to an item.

4. The standard under Section 10.33 should be conformed to that under Section 10.35 so that under both sections a practitioner may not rely upon an opinion of another practitioner unless the first practitioner is satisfied that both opinions together satisfy the applicable section. We see no justification for applying a less demanding standard under Section 10.33.

5. The requirement in Proposed Section 10.35 that the other practitioner and the date and substance of his or her opinion be described specifically should be added to Section 10.33. We see no rationale for not including that requirement in a marketing opinion.

6. The requirement in Proposed Section 10.35 that the practitioner "not be sufficiently knowledgeable" should be removed. Its meaning and application are unclear and we question whether the requirement is intended to impose a substantive restriction on the ability to use a specialist's opinion. If so, we believe that requirement to be counter productive. Provided that both the generalist and the specialist are subject to Section 10.33 or 10.35, we do not see any reason for this condition. Moreover, we believe taxpayers are best served by receiving the best possible advice – even where the generalist is "qualified." Better advice is better. Similarly, the first sentences of Proposed Sections 10.33(b)(1) and 10.35(b)(1) should be clarified by adding at the end "by that practitioner."

Tax Indifferent Parties.

RECOMMENDATION: Clarify in Sections 10.33(a)(3)and 10.35(a)(3) that the requirement that the opinion take into account the taxpayer's non-tax and tax purposes for entering into a transaction and structuring it in a particular manner includes taking into account whether the transaction involves any "tax indifferent parties" and the effects, if any, those parties' tax situations had on structuring the transaction.

Opinions issued by an in-house lawyer, accountant or other enrolled agent.

RECOMMENDATION: Clarify that Section 10.35 applies to an opinion issued by an in-house lawyer, accountant or other enrolled agent to management or the Board of Directors. Although this appears to be the intent, specificity would be helpful.

Format and Clarity of Regulations.

RECOMMENDATION: Combine Sections 10.33 and 10.35 and include more examples.

The Preamble specifically requests comments on the clarity of the Proposed Rules and how they may be made easier to understand. We recommend Proposed Sections 10.33 and 10.35 be

combined into a single section. The majority of the two sections are identical and it will be easier for practitioners to become familiar with and apply the rules if they can refer to one set of rules applicable to all Section 10.33 and 10.35 opinions and then to separate sub-rules for each of the two sections in the relatively few instances where applicable. The attached chart, comparing Proposed Sections 10.33 and 10.35 section-by section, identifies the specific differences.

We also recommend additional examples be added. We have tried in this Report to suggest some examples. No doubt Treasury and Service personnel can provide others.

Effective Date of Proposed Sections 10.33 and 10.35.

We are uncertain whether Proposed Sections 10.33 and 10.35 are intended to apply only to opinions issued after the regulations are finalized, or whether they also apply to marketing opinions issued before that date but used in marketing after that date. We believe these new rules should apply only to opinions issued after the date the regulations become final. We considered whether to recommend that an additional rule be added requiring a practitioner, who knows or has reason to know that a previously-issued opinion is being used in marketing, to contact the client to whom the opinion was issued and warn the client that the opinion was no longer to be relied upon and that the practitioner no longer authorizes the client to disseminate the opinion to taxpayers. Requiring that action seems inherently unrealistic for several reasons – the practitioner probably has no legal right to make the posited a demand and could be subject to breach of contract or similar charges if she did so.

Section 10.36. Oversight responsibility with respect to Sections 10.33, 10.34 and 10.35.

Proposed Section 10.36 provides:

> A practitioner who is a member of, associated with, or employed by a firm must take reasonable steps, consistent with his or her authority and responsibility for the firm's practice advising clients regarding matters arising under the Federal tax laws, to make certain that the firm has adequate procedures in effect for purposes of ensuring compliance with §§10.33, 10.34, and 10.35.

The Preamble to the Proposed Rules and informal public comments by Treasury and Service personnel reveal Proposed Section 10.36 is aimed at the one individual in charge of the firm's tax practice. It could be interpreted, however, as applying to every partner or employee who has any "authority or responsibility" with respect to advising clients. For example, if the senior associates in a law firm frequently supervise junior associates on specific projects, does each senior associate have an obligation under Proposed Section 10.36? We believe such a rule would be unworkable and counterproductive.

We recommend that the rule be clarified so that Section 10.36 applies only to the individual (or individuals) who has "the principal authority and responsibility for overseeing the firm's Federal tax practice of advising client(s)."

We suspect our second concern regarding Proposed Section 10.36 is the result of a typo. Specifically, Proposed Section 10.36 provides that a practitioner is subject to sanction under this

section only if the practitioner

(a) "through willfulness, recklessness, or gross incompetence does not take such reasonable steps and the practitioner and one or more persons who are members of, associated with, or employed by the firm have ... engaged in a pattern or practice of failing to comply with §10.33, 10.34 or 10.35" (emphasis added); or

(b) "takes such reasonable steps but has actual knowledge that one or more persons who are members of, associated with, or employed by the firm have ... have engaged in such a pattern or practice and the practitioner "through willfulness, recklessness, or gross incompetence, fails to take prompt action, consistent with his or her authority and responsibility for the firm's practice advising clients regarding matters under the Federal tax laws, to correct such pattern or practice."

In other words, a practitioner who *fails* to take the reasonable steps can be disciplined under this section only if *both* the practitioner and another member, associate or employee of the firm engage in the "pattern or practice"; whereas, a practitioner who *takes* the reasonable steps can be disciplined if one other person engages in the pattern and practice and the practitioner fails to take corrective action. Thus, the rules incentive a practitioner to *not* take the reasonable steps (but to personally comply with Sections 10.33, 10.34 and 10.35) because sanctions would apply in that case only if both the practitioner and another person engage in the proscribed conduct. The rule is harsher on a practitioner who takes the reasonable steps initially. Presumably, this is an error and both Proposed Sections 10.36(a) and (b) should apply if any single person (including the practitioner) engages in the pattern and practice (and the other requirements of those provisions are met). This ambiguity could be clarified by deleting "the practitioner and" from the second line of clause (a) and instead referring in both sections to "one or more persons who are members of, associated with, or employed by the firm (including the practitioner)."

Sections 10.50 through Section 10.82: Sanctions for Violations and Rules for Disciplinary Proceedings.

The Proposed Rules relating to sanctions for violations and the rules for disciplinary proceedings (Proposed Sections 10.50 through 10.82) are extremely difficult to follow and understand. We recognize these provisions are, for the most part, taken from the current version of Circular 230 with few changes. Nevertheless, we believe a number of apparent inconsistencies and potential problems can and should be resolved to improve enforcement and voluntary compliance. We believe the enforcement provisions are an extremely important and often overlooked aspect of Circular 230.

What conduct exposes a practitioner to potential sanctions?

There appear to be three categories of conduct for which a practitioner may be sanctioned under Circular 230. These are specified in Proposed Section 10.50(a) as:

1. "Incompetence and disreputable conduct": there is no specific definition of "incompetence and disreputable conduct," but a non-exclusive list of examples is set forth in Proposed Section 10.51.

2. Willfully and knowingly misleading or threatening a client or prospective client, with the intent to defraud.

3. Failure to comply with any provision of Circular 230. [90]

According to Proposed Section 10.50(a), a practitioner who commits any such conduct may be censured, suspended or disbarred.

Proposed Section 10.52, however, provides that a practitioner may be censured, suspended or disbarred for (a) "willfully violating" any provision of Circular 230, or (b) "recklessly or through gross incompetence"[91] violating Section 10.33, 10.34 or 10.35. It seems that Proposed Section 10.52 is intended to be a refinement or limitation on the more general statement made in Proposed Section 10.50 that a practitioner may be sanctioned for *any* failure to comply with any provision of the Circular 230. In other words, both Sections 10.51 and 10.52 set forth a *detailed* description of the conduct that is described, in general terms, in Section 10.50(a) as grounds for censure, suspension or disbarment. This could be clarified by making the following revisions to Sections 10.50(a), 10.51 and 10.52.

1. Adding to Section 10.50(a) "as provided for in §10.52" immediately after "fails to comply with any regulation in this part." Thus, Section 10.50(a) would read:

> . . . may censure, suspend or disbar any practitioner from practice before the Internal Revenue Service if the practitioner is shown to be incompetent or disreputable, fails to comply with any regulation in this part as provided for in §10.52, or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client.

2. Adding "pursuant to §10.50(a)" to the flush language at the beginning of Section 10.51 after the words "Internal Revenue Service." Thus, Section 10.51 would read:

> Incompetence and disreputable conduct for which a practitioner may be censured, suspended or disbarred from practice before the Internal Revenue Service pursuant to §10.50(a) includes, but is not limited to 3.

3. Rewriting the flush language at the beginning of Section 10.52 to read as follows:

> The failure to comply with any regulation in this part for which a practitioner may be censured, suspended or disbarred from practice before the Internal Revenue Service pursuant to §10.50(a) means either of the following

Confusion over what conduct may subject a practitioner to sanction re-emerges in

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[90] Presumably absent amendment to the Proposed Regulations, a practitioner could be sanctioned, suspended or disbarred from practice before the Service if the practitioner acted as a notary public in connection with her representation of her client.

[91] Recklessness and gross incompetence are defined for this purpose in Section 10.51(1).

Section 10.60(a), which provides:

> Whenever the Director of Practice determines that a practitioner violated any provision of the laws or regulations governing practice before the Internal Revenue Service, the Director may reprimand the practitioner or, in accordance with §10.62, institute a proceeding for censure, suspension, or disbarment of the practitioner.

This provision appears to have been intended to provide procedural rules only *i.e.*, to describe when and how the Director of Practice may institute a proceeding – and not to expand or limit the types of conduct subject to sanction. As written, however, it does not encompass two of the categories of conduct described as grounds for sanction in Section 10.50(a) – namely, "incompetence and disreputable conduct" and "willfully and knowingly misleading or threatening a client or prospective client, with the intent to defraud." Section 10.50(a) does not make these two types of conduct a violation of Circular 230; it simply authorizes the Secretary of the Treasury to sanction practitioners for such conduct. Therefore, technically Section 10.60 does not authorize the Director of Practice to institute proceedings with respect to incompetent or disreputable conduct or willfully defrauding a client. With respect to the third category of conduct, violation of the provisions of Circular 230, Section 10.60(a) does not contain the refinements and limitations set forth in Section 10.52(a). Accordingly, we suggest the first part of Section 10.60(a) be revised to read as follows:

> "Whenever the Director of Practice determines that a practitioner has engaged in conduct that would subject the practitioner to sanction under Section 10.50(a), the Director may ....".

It should also be clarified in Section 10.52 that a practitioner may have violated Circular 230 "willfully" or "recklessly or through gross incompetence," whether or not the practitioner knew that her conduct was a violation of Circular 230. "Willfully" generally is used to describe an action that was intended to be performed. A practitioner could perform an act intentionally, but not *know* that the act is a violation of Circular 230. While we do not think Circular 230 should be a trap for the unwary, every practitioner has a duty to be informed of the standards of discipline that apply to her practice. If practitioners could escape sanctions by reason of an actual or feigned lack of familiarity with the provisions of Circular 230, practitioners would have an affirmative incentive to never read the rules.[92] Because we believe this is an important principle, we recommend it be made clear by adding to Section 10.52 something along the lines of, "it is not necessary for the practitioner to have known that his or her conduct violated any of the regulations in this part."

What is a reprimand?

There is a second respect in which Section 10.60(a) is unclear: Section 10.60(a) introduces

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92 It seems likely that "knowingly" was intentionally omitted from these provisions for this very reason. We note that the terms "willfully and knowingly" and "knowingly" are used in various other Circular 230 provisions.

for the first time a fourth type of sanction (the other three being censure, suspension and disbarment) – "reprimand". Not only is this the only reference to reprimand anywhere in Circular 230, but it is unclear why this fourth type of sanction is being introduced in Section 10.60: Section 10.0 explicitly states that subpart C (*i.e.*, Sections 10.50 through 10.53) "prescribes the sanctions for violating the regulations" and subpart D (*i.e.*, Sections 10.60 through 10.82) "contains the rules applicable to disciplinary proceedings."

Thus, it is not clear (1) precisely what a "reprimand" is and what effect it has; (2) what, if any procedural rules, govern a determination that a practitioner should be reprimanded; and (3) whether the substantive grounds for "reprimand" are the same as those outlined in Sections 10.50(a) and 10.52(a). For example, may a practitioner be reprimanded for "incompetence and disreputable conduct" or "willfully and knowingly misleading a client with intent to defraud," or for a violation of Circular 230 not described in Section 10.52? The reference to reprimand was carried over from the existing version of Circular 230, so this point may not have been focused on in the course of drafting the proposed modifications.

In considering what a "reprimand" might be, it is usual to look at one of the important changes made by the Proposed Rules – that is, the addition of "censure" as a new method of disciplining practitioners. This addition, which we applaud, allows Treasury to take action against a practitioner that is less harsh than a suspension or full disbarment. Ideally this "intermediate sanction" will make it easier to enforce Circular 230 and increase practitioners' compliance because Treasury will be able to react to conduct that does not merit suspension but needs to be forcefully discouraged. The Proposed Rules would add to Section 10.50(a): "censure is a public reprimand." Does that mean that a "reprimand" is a private reprimand? If that is what is intended, the Proposed Rules should make that intention clear because under the currently Proposed Rules there are no limitations on how Treasury or the Service may publicize a "reprimand." We believe that in all but exceptional cases, the tax system would be best served by publishing the names of all reprimanded practitioners.

There also appear to be no procedural rules at all governing a determination to "reprimand." The Secretary of the Treasury is empowered (in Section 10.50(a)) to censure, suspend or disbar a practitioner "after notice and an opportunity for a proceeding." Sections 10.60 through 10.82 of the Proposed Rules describe in detail the procedures that must precede the actual censure, suspension or disbarment.[93] Under these provisions, the Director of Practice must advise the practitioner in writing of the facts or conduct warranting a censure, suspension or disbarment and the practitioner must be given an opportunity to provide an explanation or description of mitigating circumstances (*see* Section 10.60(c)); after this, the Director of Practice may institute a formal proceeding for a censure, suspension or disbarment (*see* Sections 10.60(a) and (c)). This proceeding essentially follows a litigation format in which the parties file pleadings (a complaint, an answer, etc.) and advances to a formal litigation-style hearing before an Administrative Law Judge ("ALJ").[94] This hearing is governed by the Administrative Procedures Act (*see* Section 10.71(a)) and various additional protections are provided for the practitioner – for example, a

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[93] The current provisions are substantively similar to the Proposed Rules.

[94] Sections 10.60 through 10.74.

printed transcript of the proceedings must be made available to the practitioner (Section 10.74); both parties are given the opportunity to submit proposed findings and conclusions and their supporting reasons to the ALJ (Section 10.75); the ALJ's decision must include a statement of findings and conclusions, the reasons or basis for those findings and conclusions and a specific order of censure, suspension, disbarment or dismissal of the complaint (Section 10.76); the practitioner has 30 days to appeal the ALJ's decision directly to the Secretary of the Treasury (Section 10.77); if there is no appeal, the ALJ's decision becomes the decision of the Secretary of the Treasury; and, if there is an appeal, the Secretary of the Treasury will make the agency's decision and transmit a copy of that decision to the practitioner.

By contrast, in the case of reprimand, Section 10.60(a) simply states that "the Director of Practice may reprimand the practitioner" in lieu of instituting a proceeding for censure, suspension or disbarment. There appears to be no requirement that a practitioner be given any advance notice, any opportunity to provide an explanation or description of mitigating circumstances or receive any explanation of what the reasons for the reprimand are. Not only does this process (or lack of process) seem to us to be fundamentally unfair, but we are also concerned it may raise constitutional due process issues. This is somewhat difficult to determine, because the scope and consequences of a "reprimand" are not described or otherwise known to us.

It also concerns us that it is not clear if, under Proposed Section 10.60(a), the Director of Practice is required, prior to issuing a reprimand, to do any fact finding, and if so, how much. The current Section 10.60(a) provides that the Director of Practice may reprimand, or institute a proceeding, if the Director "has reason to believe" a practitioner has violated Circular 230. The Proposed Rules would change this to provide that the Director may reprimand, or institute a proceeding, if the Director "determines that a practitioner" has violated Circular 230. We request the meaning of the proposed modification be explained.

The ultimate goal of the sanction rules is to encourage compliance and deter misconduct. Sanctions can further deterrence in several ways and hopefully Circular 230 will take advantage of all of these: first, the existence of sanction rules puts practitioners on notice they could be disciplined; second, when other practitioners are disciplined, if this is publicized or made known, practitioners are reminded that sanctions are possible and that violators are indeed being disciplined; and finally, if the substance of the misconduct is publicized, practitioners are educated as to what types of behavior are considered violations of Circular 230 or otherwise sanctionable.

We believe publication of the fact that sanctions have been issued, what the underlying misconduct was and, at least in some cases, what the specific terms of the sanction are would promote voluntary compliance. Threats of sanctions will be effective only if practitioners believe there is a realistic possibility that misconduct will be discovered and punished. We understand this was one of the primary reasons for adding the new sanction of "censure" – an intermediate sanction the Treasury will be able to use to combat violations that are not so egregious as to warrant suspension. Publicizing sanctions that have been issued and what those sanctions are will provide practitioners with tangible evidence and a periodic reminder that violations have unfavorable (and costly) consequences. Providing information as to the underlying misconduct would be extremely valuable to practitioners because it would bring to life the general

proscriptions contained in Circular 230 and assist practitioners in developing a clearer understanding of improper conduct.[95] Releasing the decision of the ALJ or the Secretary of the Treasury may raise concerns regarding publicizing taxpayer information, so descriptions probably would be preferable. We believe that the time and effort put into preparing the descriptions will be worth the effort. We believe these notices (with or without naming the practitioner) should be published periodically by the Service and posted permanently on the Services' website.

We also believe it crucial that Circular 230 provide standards as to what types of behavior warrant which sanctions and what the general terms of each sanction should be. Without this addition to Circular 230, we fear there will be no discernable uniformity in the sanctions issued. Two different ALJs, with the best of intentions, could impose radically different punishments on the very same set of facts. While absolute uniformity can never be guaranteed, no two sets of facts are ever precisely the same, and it is not possible to write a set of guidelines that address every situation, we believe a general set of guidelines, which will assist the ALJs without taking away their discretion, is vastly preferable to providing no guidance.

Ideally, these guidelines would prescribe which behaviors merit which sanctions and also what the terms of a reprimand, censure or suspension should be. The question of what the specific terms and consequences of a reprimand, censure or suspension are and should be is extremely important and not adequately addressed in the Proposed Rules. The Proposed Rules simply provide: if a practitioner is disbarred, he or she is not entitled to "practice before the Service," unless and until reinstated (Section 10.79(a)) and he or she may seek reinstatement after five years following disbarment (Section 10.80); if the practitioner is suspended, he or she is not entitled to practice before the Service during the period of suspension (10.79(b)); and if the practitioner is censured, the practitioner may continue to practice before the Service, subject to any conditions prescribed by the Director of Practice "to promote high standards of conduct." Section 10.80 provides that the Director of Practice may give notice of a disbarment, suspension or reprimand to "appropriate officers and employees" of the Service, to "interested departments and agencies of the Federal government," and to "the proper authorities of the State" by which the practitioner was licensed to practice. Section 10.50 also states that "censure is a public reprimand," but without any further explication. Except as noted in this paragraph, there are no provisions requiring or

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95 Currently, the issue of public access is addressed only in Section 10.90 which provides:

§10.90 – Records.

(a) Availability. The Director of Practice will make available for public inspection at the Office of Director of Practice the roster of all persons enrolled to practice, the roster of all persons censured, suspended, or disbarred from practice before the Internal Revenue Service, and the roster of all disqualified appraisers. Other records of the Director may be disclosed upon specific request, in accordance with the applicable disclosure rules of the Internal Revenue Service and the Treasury Department.

(b) Disciplinary procedures. A request by a practitioner or appraiser that a hearing in a disciplinary proceeding concerning him or her be public, and that the record of such disciplinary proceeding be made available for inspection by interested persons may be granted by the Director of Practice where the parties stipulate in advance to protect from disclosure confidential tax information in accordance with all applicable statutes and regulations.

authorizing that the other two, "harsher," sanctions be made public.

The guidelines should address, among other things:

1. How, if at all, the imposition of the sanction will be publicized. Is censure the only sanction that will be truly "publicized" and, if so, how will it be publicized and for how long? For example, if the censure is posted on the Service's website, how long should it remain on the site?

2. How much information should be given about the sanctioned practitioner? For example, should she be identified by name only, by name and city of residence? Should the practitioner's entire street address be given, the name of his or her employer or firm? Should it be stated whether he or she is an accountant, a lawyer, or an enrolled agent? What should the collateral effects of the sanction be? For example, if a practitioner is censured, should the Service be required or entitled to tell other taxpayers who are then or in the future being represented by that practitioner? If so, how long should that disclosure be permitted? What if the practitioner is suspended – can the Service tell future clients about the prior suspension after it has ended? Would this disclosure policy effectively convert a censure into a suspension or a suspension into a disbarment?

We recommend that a censure should last for a period specified by the ALJ, but lasting no longer than one year, and that during that censure period the Service may inform other taxpayers who submit or have on file an effective Form 2848 Power of Attorney with respect to the practitioner of the censure. Once a censure or suspension has lapsed (or a disbarred practitioner has been reinstated), the Service should not be permitted to provide information the prior sanction to a taxpayer. Taxpayers who seek information whether a practitioner has previously been sanctioned should be able to obtain that information – it is not clear if the roster made public by Section 10.90(a) includes previous disbarments, suspensions and censures.

3. How long a suspension should last? Since a disbarred practitioner may seek reinstatement in 5 years, we believe a suspension should last no longer than 3 years.

4. Should a prior sanction be considered when judging a subsequent charge? Generally, we think yes, unless the prior sanction was a "reprimand" and the practitioner had no opportunity to provide a defense, in which case it may be unfair for the ALJ to consider that reprimand in a subsequent case. Similar fairness concerns are presented if a prior charge that was not pursued when it was made is raised by the Service before the ALJ.

5. As for which level of sanction, if any, is appropriate for various types of misconduct we believe the guidelines should include instructions as to what factors should be considered by the ALJ. First, the ALJ should consider any explanation or description of mitigating circumstances provided by the practitioner. As indicated above while the accused practitioner is given the opportunity to provide an explanation or description of mitigating circumstances to the Director of Practice before the proceedings are instituted, but there currently is no requirement that the Director of Practice consider these matters prior to instituting the proceeding or, more importantly, that the ALJ be given the same information or take the mitigating matters into account. Given the complexities of some of the Proposed Rules and the lack of familiarity and experience that practitioners will have with these new rules in the first few

years after they are adopted, we think it would be appropriate to provide specifically that the ALJ should take into account a practitioner's good faith attempts to comply with Circular 230 and whether the practitioner believed her conduct was consistent with the purposes behind the rules. The ALJ should also take into account whether the practitioner has previously been sanctioned and what the prior misconduct was. We also believe the ALJs should be given guidance as to whether the amount of money involved and/or the number of taxpayers hurt should be considered.

6. The guidelines should also address what "practice before the Service" means, so that a suspended or disbarred practitioner knows what she is and is not permitted to do. Proposed Section 10.2(e) provides:

> Practice before the Internal Revenue Service comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings.[96]

This seems to suggest that practitioner could continue to render advice and issue opinions to taxpayers, so long as the practitioner never "presents" or prepares to be presented to the Service any document relating to a taxpayer/client. This seems not to be the intention of the sanctions rules. For example, it seems unlikely that it is anticipated that a suspended practitioner could issue a marketing opinion subject to Section 10.33, or issue a more likely than not opinion that is subject to Section 10.35.[97]

Confidentiality Agreements.

RECOMMENDATION: Confidentiality agreements should not be addressed in Circular 230 because these agreements present issues that are within the venue of the bodies governing the professions. If Circular 230 addresses confidentiality agreements, it should be limited to requiring that a practitioner who imposes confidentiality on a client treat this as a conflict that needs to be disclosed and consented to.

One of Treasury's notices preceding the issuance of the Proposed Rules asked whether there are circumstances in which a practitioner should be prohibited from agreeing with a client to

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[96] *See, also,* Proposed Section 10.24: "A practitioner may not, knowingly and directly or indirectly: (a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Service."

[97] If the opinion causes the practitioner to be an income tax return preparer under Code Section 7701(a)(36) and Regulations Section 301.7701-15 (for purposes of Code Section 6694), this would seem clearly to constitute "practice before the Internal Revenue Service" under the Proposed Rule. Nevertheless, we believe that issuing penalty protection opinions should constitute "practice before the Service" even if it does not qualify the author to be an "income tax return preparer."

conditions of confidentiality (other than those imposed by reasons of privilege) and whether a practitioner should be prohibited from asking a client to agree to conditions of confidentiality.

We addressed these questions in our July 2000 Report, where we said: (i) as a result of the new tax shelter registration regulations issued last year, tax shelter promoters have, to a large extent, eliminated conditions of confidentiality (to avoid a registration requirement); (ii) where confidentiality is imposed, the practitioner may have an ethical problem representing other clients entering into similar transactions but the ethical aspects should not be regulated by tax authorities; and (iii) a practitioner should be entitled to request confidentiality from clients to protect the practitioner's ideas because this is what the practitioner is in the business of selling and any prohibitions on these agreements are not a matter for tax enforcement.

The Proposed Rules do not prohibit confidentiality agreements. The Preamble noted the points we had made and indicated that others had made them as well, but said the Treasury "remains concerned" and invites comments on whether confidentiality restrictions should be addressed and, if so, in what manner. We continue to believe Circular 230 is not the appropriate venue for addressing confidentiality agreements between tax practitioners and their clients.

To the extent the concern is that confidentiality agreements will reduce or eliminate the chances a corporate tax shelter will be detected and scrutinized by the Service, this concern has been addressed by the new tax shelter disclosure and registration regulations under Code Sections 6011 and 6111, which use confidentiality as one of the triggers requiring disclosure and registration, respectively. Confidentiality is a trigger under these regulations whether the confidentiality is being requested by the client or the practitioner.

To the extent the concern is that client-imposed confidentiality may jeopardize a practitioner's ability to fulfill his or her professional responsibilities to other clients, we believe this is a matter of professional responsibility and professional ethics more appropriately regulated by the relevant body governing the profession — *e.g.*, in the case of lawyers, the state bar. Tax advisors, as well as advisors providing other legal and accounting advice, face these issues repeatedly, even where there is no explicit confidentiality agreement. All advisors should be educated about and sensitive to these issues and to the different means of addressing and resolving them. For example, a firm may turn down as assignment because it foresees that the assignment would require it to draw on ideas it had developed jointly with another client in the course of a prior engagement. Often this is done simply as a matter of good client relations (rather than because of an explicit contractual prohibition against sharing the jointly-developed ideas). A firm also may turn down as assignment from a prospective client because of concerns the firm may learn information in the course of the assignment that would subsequently create a conflict with work that the firm might be requested to do for a pre-existing client.

Because we believe this issue arises for lawyers practicing in various fields, and for accountants providing tax advice as well as auditing and financial accounting services, and does not pose a meaningful risk with respect to the proper enforcement of the revenue laws, we believe the matter should be regulated by bodies governing the professions and not by the taxing authorities.

Appendix A

26 Op. Atty. Gen. 236

DEPARTMENT OF JUSTICE,

April 18, 1907.

SIR: I duly received your request for my opinion whether the "proviso" in the recent act of Congress (34 Stat., 622), amending section 558 of the Code of the District of Columbia applies to local notaries only or to notaries throughout the country. Briefs on both sides of the question and an opinion of the Assistant Attorney-General for your Department accompanying your letter have been carefully considered by me.

Section 558 before amendment was as follows:

"Notaries: The President shall also have power to appoint such number of notaries public, residents of said District, as, in his discretion, the business of the District may require."

The amendatory act, complete, is as follows:

"AN ACT To amend section five hundred and fifty-eight of the Code of Law for the District of Columbia.

"*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,* That section five hundred and fifty-eight of the Code of Law for the District of Columbia, relating to notaries public, be amended by adding at the end of said section the following: '*Provided*, That the appointment of any person as such notary public, or the acceptance of his commission as such, or the performance of the duties thereunder, shall not disqualify or prevent such person from representing clients before any of the Departments of the United States Government in the District of Columbia or elsewhere, provided such person so appointed as a notary public who appears to practice or represent clients before any such Department is not otherwise engaged in Government employ, and

shall be admitted by the heads of such Departments to practice therein in accordance with the rules and regulations prescribed for other persons or attorneys who are admitted to practice therein: *And provided further,* That no notary public shall be authorized to take acknowledgments, administer oaths, certify papers, or perform any official acts in connection with matters in which he is employed as counsel, attorney, or agent [or][sic] in which he may be in any way interested before any of the Departments aforesaid.'"

Do the words "no notary" in the last sentence mean *no notary of the District of Columbia*, or is the prohibition general? This question is not altogether free from difficulty.

It appears probable that this second proviso was added to the bill to meet an objection raised by the Secretary of the Treasury and the Comptroller, which is thus stated by the latter officer:

> "Persons who are notaries public and not Government employees may, in the business represented by them as attorneys before the Departments, act as notaries -- e.g., have executed before them affidavits and powers of attorney -- in cases in which they are acting as attorneys in claims before the Departments. Such practice, in my opinion, would open the doors to fraud and deceit."

I do not see that any sufficient reason exists for limiting the prohibition contained in this proviso to notaries public of the District of Columbia; the practice it was intended to prevent is no less objectionable on the part of other notaries than on theirs. Doubtless the law was originally intended to remove a legal disability which affected only notaries of the District. But it must be remembered that the one legislative body, by one method of lawmaking at one and the same sitting, enacts laws for at least three different classes of business in the District. It makes laws to be applied by the Executive Department, situated in the District, to the whole country; it makes laws to regulate the practice and management of those Executive Departments themselves; and it is the legislature of the District considered as a quasi Territory. There is no constitutional or other legal obstacle to the embodiment of laws of all three kinds in one act.

Such being the case, when debate or committee deliberation may suggest a wise and needed rule of law, so busy a body as the Congress may be unwilling to postpone its enactment merely to

effect a logical separation of subjects among these three classes. The Senate added this final proviso to the bill after it had passed the House.

The amendatory law not only deals with notaries of the District, but also with the practice and management of the Executive Departments and with the relations of notaries to that practice.

The attention of the Congress being thus directed to the subject of departmental practice, it seems, to my mind, reasonable to believe that when it said "no notary public" shall act as such in cases in which he is attorney before any of the Departments, it meant what it said; that is to say, it intended to embrace all the notaries who could practice before those Departments.

The fact that the enactment took the form of a proviso in an act relating in other respects to notaries of the District is unquestionably entitled to weight; but it is not decisive. Had Congress intended to restrict the operation of the proviso to notaries of that District, it could have inserted the word "such" or some equivalent qualifying expression, as it actually did in the body of the act. Not having done this, I feel bound to assume it acted advisedly and intended to say what it said in fact. Therefore, although there may be room for a reasonable divergence of views in the premises, I am, on the whole, of the opinion, that the proviso applies to all notaries who may practice before the Departments.

Respectfully,

CHARLES J. BONAPARTE.

THE SECRETARY OF THE INTERIOR.

Appendix B

Proposed Circular 230 Rules
§§10.33, 10.34, 10.35 and 10.36

Subsection Heading (10.33)	§10.33 Tax Shelter Opinions Used by Third Parties to Market Tax Shelters	Subsection Heading (10.35)	§10.35 More Likely Than Not Tax Shelter Opinions
(a) In general.	Requirements for a tax shelter opinion that does not conclude that the Federal tax treatment of a tax shelter item or items is more likely than not the proper treatment and will be used in marketing (as described in the definition of a "tax shelter opinion" in 10.33(c)(4)).	(a) In general.	Requirements for a tax shelter opinion that does conclude that the Federal tax treatment of a tax shelter item or items is more likely than not (or higher) the proper treatment.
(a)(1) Factual matters. (a)(1)(i)	Practitioner must inquire as to all relevant facts, be satisfied that opinion takes into account all relevant facts, be satisfied that material facts (including assumptions and representations) are accurately and completely described in opinion (and in any related offering or sales promotion materials).	(a)(1) Factual matters. (a)(1)(i)	Identical.
(a)(1)(ii) Reliance on factual assumptions.	Opinion must not be based on any unreasonable factual assumptions, which includes any assumption practitioner could reasonably request to be provided or represented.	(a)(1)(ii) Reliance on factual assumptions.	Identical, except that: unreasonable factual assumptions include any assumption that the transaction has a business reason, is potentially profitable apart from tax benefits, or with respect to a material valuation issue. (10.35(a)(1)(ii)(C)).

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(a)(1)(iii) Reliance on factual representations.	May rely on factual representations, if reasonable, based on all facts and circumstances (including whether person making representations is knowledgeable and the appropriate person). Representations must be complete – e.g., cannot state that there are business reasons for transactions without describing those reasons, and cannot state that profitable apart from tax benefits without providing adequate factual support.	(a)(1)(iii) Reliance on factual representations.	Identical.
(a)(2) Relate law to facts.	Opinion must clearly identify the facts upon which the conclusions are based, must contain a reasoned analysis of pertinent facts and legal authorities, may not assume the favorable resolution of any Federal tax issue material to the analysis, may not rely on any unreasonable legal assumptions, and may not contain any inconsistent legal analyses or conclusions with respect to Federal tax issues.	(a)(2) Relate law to facts.	Identical.

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(a)(3) Analysis of material Federal tax issues.	Practitioner must ascertain that all material Federal tax issues have been considered. Opinion **must state** that practitioner has considered possible application of all potentially relevant judicial doctrines, including the step transaction, business purpose, economic substance, substance over form and sham transaction doctrines, and potentially relevant statutory and regulatory anti-abuse rules; and opinion **must include** an analysis as to whether the tax shelter item is vulnerable to challenge under all potentially relevant doctrines and anti-abuse rules (taking into account the typical investor's tax and non-tax purposes (and their relative weight) for entering into and for structuring transaction in a particular manner).	(a)(3) Analysis of material Federal tax issues.	Identical, except substitutes "taxpayer" for "typical investor".

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(a)(4) Evaluation of material Federal tax issues. Conclusion as to likelihood will prevail on merits with respect to each material Federal tax issue that involves the reasonable possibility of IRS challenge.	(a)(4) ! Must conclude as to the likelihood that a typical investor will prevail on the merits with respect to each material Federal tax issue that involves the reasonable possibility of a challenge by the IRS, or ! to the extent such a conclusion cannot be reached, must clearly state that practitioner is unable to reach a conclusion with respect to those issues; and ! must fully describe the reasons for reaching or, as the case may be, being unable to reach a conclusion.	(a)(4)(i) Evaluation of material Federal tax issues. Conclusion as to likelihood will prevail on merits with respect to each material Federal tax issue that involves the reasonable possibility of IRS challenge.	(a)(4)(i) ! Same as first bullet point (except must relate to an investor if investors known); ! may not state that unable to opine with respect to certain material Federal tax issues (including but not limited to whether the transaction has a business purpose or economic substance); and ! no specific requirement that opinion fully describe the reasons for the conclusions.
(a)(5) Overall conclusion. Conclusion as to whether Federal tax treatment of the tax shelter item(s) is the proper tax treatment.	(a)(5)(i) Must clearly provide an overall conclusion as to the likelihood that the Federal tax treatment of the tax shelter item or items is the proper treatment; or, to the extent such an overall conclusion cannot be reached, must clearly state that practitioner is unable to reach such an overall conclusion. Opinion must fully describe the reasons for the inability to reach a conclusion (if applicable).	(a)(4)(ii) Overall conclusion. Conclusion as to whether Federal tax treatment of the tax shelter item(s) is the proper tax treatment.	Must unambiguously conclude that the Federal tax treatment of the tax shelter item or items is more likely than not (or higher) the proper tax treatment. Conclusion may not be based solely on the conclusion that the taxpayer will more likely than not prevail on the merits as to each material Federal tax issue.

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Overall conclusion (...continued) (a)(5)(ii) and (iii). Disclosures required on first page of opinion.	(a)(5)(ii) The first page of the opinion must clearly and prominently disclose that opinion: ! does not conclude that the Federal tax treatment of the tax shelter item or items is more likely than not the proper treatment, or that the practitioner is unable to reach an overall conclusion as to the likelihood that the treatment of a tax shelter item is proper; and ! that the opinion was not written for the purpose of establishing reasonable belief or reasonable cause and good faith under Section 6662(d)(2)(C)(i)(II) or 6664(c)(1).		None.
(a)(5)(iv). May not take "audit lottery" into account.	In complying with (a)(3) and (a)(4), may not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled.	(a)(4)(iii). May not take "audit lottery" into account.	Identical.
(a)(6) Description of opinion in written materials or promotional efforts.	Must take reasonable steps to assure that any written materials or promotional efforts that include or refer to opinion, correctly and fairly represent nature and extent of opinion.	(a)(5) Description of opinion in written materials or promotional efforts.	Identical.

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(b) Competence to provide opinion; reliance on opinions of others. (b)(1)	The practitioner must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered.	(b) Competence to provide opinion; reliance on opinions of others. (b)(1)	Identical.

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(b)(1)(i) and (ii)	A practitioner may not provide a tax shelter opinion that fails to conclude both as to the likelihood that a typical investor will prevail on the merits with respect to each material Federal tax issue that involves the reasonable possibility of a challenge and as to the likelihood that the Federal tax treatment of the tax shelter items is proper (or states that are unable reach any such conclusion), unless – ! at least one other competent practitioner provides an opinion on the likely outcome with respect to all of the other material Federal tax issues which involve a reasonable possibility of challenge by the IRS, and with respect to the tax shelter item or items; ! the practitioner, on reviewing such other opinion and any written materials that distribute, reflect or refer to such opinions, has no reason to believe that the other practitioner did not comply with the standards of 10.33(a) or that the overall conclusion reached by the other practitioner is incorrect on its face; and ! the practitioner's own limited opinion otherwise satisfies the applicable requirements of 10.33.	(b)(1), (2) and (3)	If the practitioner is not sufficiently knowledgeable to render an informed opinion with respect to particular material Federal tax issues, then the practitioner may rely on the opinion of another practitioner with respect to such issues, provided the practitioner – ! is satisfied that the other practitioner is sufficiently knowledgeable and has no reason to believe that the other opinion should not be relied on; ! clearly identifies the other practitioner, states the date on which the opinion was rendered, and sets forth the conclusions reached in such opinion; and ! is satisfied that the combined analysis, taken as a whole, satisfies the requirements of 10.35.

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(b)(2) Financial forecasts and projections.	A practitioner-who makes financial forecasts or projections relating to or based on the tax consequences of the tax shelter that are included in written materials disseminated to any or all of the same persons as the opinion-may rely on the opinion of another practitioner as to any or all material Federal tax issues, provided the practioner who is relying on the other opinion – ! has no reason to believe that the practitioner rendering the other opinion has not complied with 10.33(a); ! the first two bullet points set forth in the prior section are satisfied; and ! any material Federal tax issues not covered, or incorrectly opined on, by the other opinion, are disclosed in the financial forecasts/projection report and opined on in a manner that satisfies 10.33(a).	(b)(4) Financial forecasts and projections.	Very similar, but not identical.
(c) Definitions. (c)(1) *Practitioner.*	Attorneys, certified public accountants, enrolled agents and enrolled actuaries (as defined in 10.3).	(c) Definitions. (c)(1) *Practitioner.*	Identical.

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(c)(2) *Tax shelter.*	As defined in Section 6662(d)(2)(C)(iii), meaning "(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."	(c)(2) *Tax shelter.*	Identical, except excludes municipal bonds and qualified retirement plans.
(c)(3) *Tax shelter item.*	An item of income, gain, loss, deduction or credit if the item is directly or indirectly attributable to a tax shelter as defined above.	(c)(3) *Tax shelter item.*	Identical.
(c)(4) *Tax shelter opinion.* Written advice.	! Written advice by a practitioner concerning the Federal tax aspects of a tax shelter item or items ! that a practitioner knows or has reason to believe will be used or referred to by a person other than the practitioner (or representative of his firm) in, privately or publicly, promoting, marketing or recommending the tax shelter to one or more taxpayers.	(c)(4) *Tax shelter opinion.* Written advice.	Identical to first bullet point.

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Tax shelter opinion. Offering materials.	Includes the Federal tax aspects or tax risks portion of offering materials prepared by or at the direction of a practitioner, whether or not a separate opinion letter is issued and whether or not the practitioner's name is referred to in offering materials or in connection with sales promotion efforts. Does not include advice provided in connection with the review of portions of offering or sales promotion materials, provided neither the name of the practitioner or the practitioner's firm, nor the fact that a practitioner has rendered advice concerning Federal tax aspects, is referred to in such materials or related sales promotion efforts.	*Tax shelter opinion.* Offering materials.	Identical.
Tax shelter opinion. Financial forecasts or projections.	Also includes ! a financial forecast or projection, if it is predicated on assumptions regarding Federal tax aspects of the investment, and ! if practitioner knows or has reason to believe will be used or referred to by a person other than the practitioner (or a representative of his firm) in, publicly or privately, promoting, marketing or recommending the tax shelter.	*Tax shelter opinion.* Financial forecasts or projections.	Identical to first bullet point.
(c)(5) *Material Federal tax issue.*	(c)(5) Identical to 10.35(c)(5) with the following addition: includes the potential applicability of penalties, additions to tax, or interest charges that reasonably could be asserted by the IRS with respect to the tax shelter item.	(c)(5) *Material Federal tax issue.*	Any Federal tax issue the resolution of which could have a significant impact on a taxpayer under any reasonably foreseeable circumstance.

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	None.	(d) Effect of opinion that meets 10.35 standards.	An opinion that meets 10.35 requirements will satisfy the practitioner's responsibilities under this section, but the persuasiveness of the opinion with regard to tax issues in question and the taxpayer's good faith reliance on the opinion will be separately determined under applicable provisions of the law and regulations.
	None	(e) Advisory Committee.	For purposes of advising the Director of Practice whether an individual may have violated 10.33 or 10.35, the Director is authorized to establish an Advisory Committee of at least five individuals authorized to practice before the IRS. This committee will review and make recommendations with regard to alleged violations of 10.33 or 10.35.

10.34 Standards For Advising With Respect to Tax Return Positions and For Preparing or Signing Returns.

Only one substantive change: In definition of "realistic possibility of being sustained on the merits," existing rules say cannot take into account possibility of return not being audited or issue not being raised. Proposed Rules would add that also may not take into account the possibility that the issue will be settled or audited. Compare 10.34(a)(4)(i) of current Rules to 10.34(d)(i) of Proposed Rules.

10.36 Procedures to Ensure Compliance with 10.33, 10.34 and 10.35

Any practitioner who is a member of, associated with, or employed by a firm must take reasonable steps, consistent with his or her authority and responsibility for the firm's Federal tax practice, to make certain that the firm has adequate procedures in effect for purposes of ensuring compliance with 10.33, 10.34 and 10.35. Practitioner who fails to comply may be subject to disciplinary action if, and only if –

(a) practitioner through willfulness, recklessness or gross incompetence does not take such reasonable steps and the practioner and one or more members, associates or employees of the firm have, in connection with their practice with the firm, engaged in a pattern or practice failing to comply with 10.33, 10.34 or 10.35; or

(b) practitioner takes such reasonable steps but has actual knowledge that one or more persons who are members, associates or employees of the firm have engaged of any such pattern or practice and, through willfulness, recklessness, or gross incompetence, fails to take prompt action, consistent with his or her authority and responsibility for the firm's Federal tax practice, to correct such pattern or practice.