NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report On Circular 230 Regulations

March 3, 2005

Table of Contents

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REPORT ON CIRCULAR 230 REGULATIONS*

I. Introduction

This report of the New York State Bar Association Tax Section offers recommendations with respect to the regulations regarding practice before the Internal Revenue Service (the "Service") that the U.S. Department of the Treasury (the "Treasury") and the Service published in the Federal Register on December 20, 2004 (the "December Regulations"). The December Regulations amend Circular 230 by providing aspirational "best practices" for tax advisors and new requirements for "covered opinions" and other written advice.[1]

The December Regulations are intended to bolster the Treasury's and the Service's efforts to combat tax shelters and enhance public "confidence in the honesty and integrity"[2] of tax professionals. We understand that the December Regulations are intended to deter taxpayers from engaging in abusive transactions by limiting or eliminating their ability to avoid penalties through inappropriate reliance on a tax advisor's advice. We also understand that the December Regulations are aimed at preventing unscrupulous tax advisors and promoters from marketing abusive transactions to large numbers of customers (and, in particular, unsophisticated taxpayers) based on an opinion that fails to consider adequately the facts of the particular transaction. As you know, we strongly support these goals.

However, we believe that the December Regulations as written impose burdens on *desirable* tax advice and that these burdens are disproportionate to the benefits that the December Regulations offer. The regulations constrain *all* written tax advice. While their target is the tax shelter advice described above, most written tax advice does not fit that model. Taxpayers seek tax advice in a variety of circumstances, generally to understand and comply

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[1] 31 CFR part 10, reprinted as Treasury Department Circular 230.

[2] Preamble to the December Regulations.

with the tax law, rather than to skirt it. By burdening all written tax advice, the December Regulations make desirable advice more difficult for taxpayers to receive. The December Regulations thus interfere with voluntary compliance.

Much of our practice involves advising corporate clients with respect to discrete commercial transactions or on an ongoing basis with respect to matters that arise in the ordinary course of a client's business. In our transactional practices, we provide advice with respect to many different types of transactions, such as mergers and acquisitions, leveraged buyouts, investment partnerships, internal restructurings, spin-offs, debt or equity offerings and other financial instruments. We also advise individuals on personal matters, including the purchase and sale of homes, the structuring or acceptance of deferred compensation arrangements, marriage and divorce, and the transmission of assets to family members during life and at death.

The context of our advice is likewise varied. Some of our advice responds to abstract questions, where the client has no specific transaction in mind. Ultimately, a specific course of action might, or might not, arise. When we do advise with respect to specific transactions, the advice occurs at all stages of the process (initial "noodling" over structure, revision to the proposed structure, documentation, before and after signing, and before and after closing). In many cases, our advice is not presented to a client in a single memorandum at a single point in time but rather on an ongoing basis over the course of months or even years. Further, recipients of our advice range from sophisticated in-house tax professionals to sophisticated businesspeople with financial expertise (*e.g.*, Treasurers or Chief Financial Officers) to sophisticated businesspeople with legal expertise (*e.g.*, General Counsels) to less sophisticated businesspeople and investors.

Further, our advice takes many forms. Although we sometimes write full-blown opinions or memoranda with respect to specific transactions, our advice is often provided in short emails, quick memos, and even PowerPoint presentations. And, our tax advice is often incorporated in a document that includes non-tax advice. The form of our advice is generally tailored to the sophistication, tax expertise and expectations of our clients, the nature of their inquiry, and the stage of any relevant transaction. Relatively little of this advice is in the nature of a formal full-blown opinion of the type contemplated by the December Regulations.

Although the target of the December Regulations is tax shelters, the December Regulations would constrain all written tax advice to fit within prescribed limitations. The regulations would prohibit some advice and require the rest to comply with detailed rules and requirements or contain specific cautionary banners. We believe that the December Regulations will discourage us from providing our clients with helpful written advice. Further, the December Regulations will increase the cost to our clients of receiving written advice, because complying with the requirements of the December Regulations will take considerably more time. [3]

The December Regulations include an elaborate "opt-out" system that is intended to ameliorate these burdens, but the opt-out system provides only marginal relief. First, the opt-outs are available only for certain types of written advice. Thus, an advisor wishing to opt out must work his or her way through a maze of nuanced judgments to determine whether an opt-out is available and, if so, what types of disclosures the written advice must bear. Moreover, for some written advice, the advisor cannot opt out and therefore must comply with the requirements of Section 10.35, regardless of whether the client wishes advice of that extensive nature or whether the client wishes to pay for such advice. Indeed, in many cases, extensive advice of the type required by Section 10.35 is not even possible, given that such advice is often requested in the abstract and not with respect to any specific transaction that has relevant facts.

Second, where an opt-out is available, the written advice must include a cautionary banner. We are concerned that clients may view the banners as heavy-handed, causing them to distrust our advice. Others may view the banners as mere boilerplate that they can safely ignore.

Thus, the December Regulations as currently drafted are ill-suited to the vast bulk of tax practice. The constraints of the regulations will impede taxpayers' ability to receive

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[3] Senior Treasury officials have been reported in the press to have stated that the December Regulations should be interpreted reasonably and with common sense. The clear implication of these comments is that the regulations are subject to a more literal interpretation that would impose unreasonable burdens on tax advice. While we agree with the sentiments expressed by these Treasury officials, an employee of the Office of Professional Responsibility, an administrative law judge, or a Court could well apply the plain language of the regulations literally. Thus, we believe that the exceptions and clarifications set forth in this report should be adopted or that the preamble to the regulations should expressly state that the regulations should be interpreted reasonably in the context of the circumstances (or both).

timely tax advice. Instead of focusing on the substantive tax questions posed by a client, a tax advisor will have to spend precious time analyzing what type of written advice he or she may provide, whether an opt-out applies and what disclosure must be placed on the written advice. In many cases, oral advice will be provided instead of written advice. In other cases, banners will be placed on written advice which will either be ignored by recipients or will confuse them or raise suspicion. The banners may have the effect of reminding taxpayers that penalty protection is not available, a limited achievement, considering that penalty protection would not have been available anyway in many cases.

Thus, although we strongly support the objectives that underlie the December Regulations, we believe that, as currently drafted, they will do more harm than good. Therefore, on balance, we recommend a more targeted approach.

- Our primary recommendation in this report is that the IRS and Treasury apply an "opt-out" approach only to marketed opinions and written advice with respect to listed transactions. For all other written advice, the advisor would not be required to comply with the Section 10.35 requirements unless the advisor "opts-in" to the regime by specifically stating in his or her written advice that it is intended to be relied upon by the taxpayer as "reasonable cause" for taking a tax position and therefore may provide some protection against the potential imposition of penalties. If the advisor "opts in," the advisor would be required to comply with the requirements of Section 10.35 and would be subject to sanctions if he or she does not.

- Under this approach, we would also recommend that the penalty provisions be amended to provide that taxpayers may not rely on written advice for penalty protection unless the written advice specifically states that it is intended to be so relied upon, and we believe that the IRS and Treasury should publicize this change.

We believe that this approach would prove far more practical and administrable than the December Regulations. Under our recommended opt-in system, a practitioner who placed the banner on written advice would be subject to sanctions if the practitioner did not comply with the requirements of Section 10.35. We believe that the opt-in approach would enhance voluntary compliance with the tax law better than the opt-out approach of the December Regulations.

- We recommend, however, an "opt-out" approach for marketed opinions and written advice with respect to listed transactions. That is, we recommend that you require marketed opinions and written advice with respect to listed transactions to comply with the requirements for covered opinions contained in Section 10.35 unless the written advice states that (a) the advice could not be relied upon for penalty protection, (b) in the case of marketed opinions, that it was written for the purpose of marketing a transaction and that the recipient should seek advice of independent counsel and (c) in the case of advice regarding listed transactions, that it related to a listed transaction. We refer to our recommended opt-in system, together with these special rules, as our "Primary Recommendation."

These special rules would guard against tax shelter promoters misleading unsophisticated taxpayers into thinking they had received opinions that they had not received. As you may recall, our report commenting on the December 2003 proposed Circular 230 regulations recommended restricting the covered opinion requirements to a narrow category of written advice and discussed both an opt-in and an opt-out approach. At that time, a narrow majority of our members favored opt-in and a significant minority favored opt-out.[4] After having had the opportunity to review the opt-out system of the December Regulations, we overwhelmingly believe that the opt-out system adopted in the December Regulations should be abandoned.

The opt-in approach that we recommend would address many of the concerns we have about the December Regulations. For example, it would permit most informal written correspondence between a client and a tax advisor, such as brief e-mails, without the need for intrusive banners.

Our Primary Recommendation would also allow advisors to give short-form written advice on a transaction the principal purpose of which is tax avoidance. We believe there are circumstances where clients may want to know whether a principal purpose transaction, such as a *Castle Harbour* loss-generating transaction or a *Cottage Savings* loss-generating transaction, that appears to have been blessed by a court really works, and it would be appropriate for a lawyer to respond, "it depends," and describe circumstances in which it might work and how

[4] New York State Bar Association Tax Section, Report on Proposed Amendments to Circular 230 (March 24, 2004).

they relate to the client's current circumstances. It would likewise be appropriate for a lawyer to say, "it might work if you had the right facts and a good business purpose" and go on to elaborate in writing on the point without generating a lengthy opinion based on facts which must necessarily be made up because the actual facts do not exist yet and the transaction is not likely to occur. We do not think it desirable or appropriate to forbid advisors to give such advice.

Further, the distinction between "a significant purpose" and "the principal purpose" is too ephemeral to bear its own weight. In many cases, it would be difficult for an advisor to determine which category a transaction belonged to, and the ultimate classification would often be one of idiosyncratic judgment. For example, is tax avoidance the principal purpose of the issuance of the contingent convertible debt obligations described in Rev. Rul. 2002-31? Moreover, the distinctions among covered opinions, reliance opinions, marketed opinions and general advice are sufficiently complex that their further multiplication by a key distinction between "the principal purpose" and "a significant purpose" introduces a degree of analytic complexity into the calculus of a lawyer's obligations that is out of proportion to the benefits of the regulations.

We recognize that listed transactions are the most aggressive types of transactions and, like marketed opinions, should be subject to special rules. Under our Primary Recommendation, advisors would be permitted to provide written advice on listed transactions, but this advice would be subject to the "opt-out" approach of the December Regulations. In other words, written advice regarding listed transactions would be permitted either in the form of a full-blown covered opinion subject to Section 10.35 or, if appropriate protective banners are included, in a shorter form.

In short, we believe that our recommendations properly balance the tax policy goals of permitting taxpayers to receive written tax advice in a timely and efficient manner and protecting taxpayers against opportunistic and misleading tax advice. However, we recognize that the IRS and Treasury may disagree with our Primary Recommendation. Therefore, we also provide recommendations in this report on the December Regulations in the event that the IRS and the Treasury decide to retain the opt-out system of the December Regulations:

- Informal written communication (other than marketed opinions and advice regarding listed transactions) should be excluded from the definition of "covered opinion" pursuant to an exclusion for written advice that the intended recipient could not reasonably construe as advice that could be relied upon for avoiding penalties. Any written advice (other than marketed opinions and advice regarding listed transactions) that includes at the top, bottom or elsewhere in the written communication a statement to the effect that the written advice cannot be relied upon for penalty protection would be excluded from the definition of covered opinion.

- The distinction between "the principal purpose" and "a significant purpose" should be eliminated, thus permitting an opt-out for written advice with respect to a transaction the principal purpose of which is tax avoidance, permitting the SEC exclusion to apply to such transactions and permitting limited scope opinions to be given with respect to such transactions.

- There should be an opt-out for written advice regarding listed transactions.

- The December Regulations should clarify how they apply to written advice regarding hypothetical transactions.

- The concept of a "limited scope" opinion is unclear. Most formal tax advice does not reach an ultimate conclusion on deductibility, gain or loss recognition or the like, but rather concludes that certain Code sections will or will not apply. We believe that the concept of limited scope should either be clarified or eliminated. If it is retained, more types of written advice should be permitted to be limited scope.

Finally, regardless of whether our recommended opt-in system is adopted or the IRS and Treasury retain the opt-out system of the December Regulations:

- The concept of a "marketed opinion" should be narrowed. As drafted, the definition sweeps far beyond the types of written advice used to market tax shelters.

- The exclusion for written advice included in documents filed with the SEC should be clarified to include advice that is described, but not included, in SEC documents.

- We suggest several clarifications to the Section 10.35 requirements for covered opinions.

- We believe that Section 10.37 is too ambiguous to support practitioner sanctions and should be eliminated. If it is not eliminated, we believe that it should be interpreted to permit quick informal written advice.

II. Summary of December Regulations

Section 10.35 imposes elaborate standards on written advice that constitutes a "covered opinion."[5] Section 10.37 imposes looser standards on written advice that does not constitute a covered opinion. The December Regulations impose almost no constraints on oral advice.

A "covered opinion" is "written advice (including electronic communications)"[6] concerning one or more "Federal tax issues" arising from: (1) a transaction that is the same or substantially similar to a transaction that is listed under Treasury Regulation Section 1.6011-4(b)(2) (a "Listed Transaction"); (2) a "partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose" of which is the "avoidance or evasion" of tax (a "Principal Purpose Transaction"); or (3) a "partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose" of which is the "avoidance or evasion" of tax (a "Significant Purpose Transaction") if the written advice is (i) a "reliance opinion," (ii) a "marketed opinion," (iii) subject to "conditions of confidentiality" or (iv) is subject to "contractual protection."[7]

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5 The Preamble to the December Regulations states that the scope of the Regulations is "limited to practice before the IRS." This is appropriate, because the statute that contemplates the December Regulations, Section 330 of Title 31 of the United States Code, contemplates regulation of practice before the Treasury. The December Regulations appear to assume that all written tax advice falls within the purview of this limitation. We question whether this assumption is correct.

6 We interpret the term "advice" to exclude submissions to the government (such as ruling requests and audit correspondence) and advocacy pieces (such as litigation briefs), because the primary recipient is not a taxpayer. We also interpret the term "advice" to exclude articles, treatises, bar reports, speeches and materials prepared for conferences.

7 The Internal Revenue Manual defines "avoidance" of tax broadly. It states that "[o]ne who avoids tax does not conceal or misrepresent. He shapes events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure." Internal Revenue Manual 9.1.3.3.2.1 (07-29-1998). The IRS Manual provides that a taxpayer who decides to sell stock within the short-term capital gain holding period, but upon realizing that the tax rate will be lower if he holds for an extra few weeks, defers the sale until then has a purpose of tax avoidance. Given this broad description of tax avoidance, any transaction that results in a reduction of potential tax liability, including as a result of a non-recognition provision of the Code, could be viewed by the Service as having a significant purpose of tax avoidance.

We do not necessarily agree with the Service's definition of tax "avoidance." The definition appears to cover all tax planning, including well-recognized legitimate means of reducing taxes. Indeed, the Service's concept of tax avoidance appears to compare the taxpayer's taxes against the taxes that would arise in a system that contained neither a realization requirement nor a recognition requirement. Yet, these requirements are well-

Certain types of advice are excluded from the definition of covered opinion. Written advice provided to a client is excluded if the practitioner is "reasonably expected to provide subsequent written advice" that satisfies Section 10.35[8] (the "Preliminary Advice Exclusion"). Written advice that is "included" in documents "required to be filed with the Securities and Exchange Commission" is also excluded provided that the advice does not pertain to a Listed Transaction or a Principal Purpose Transaction (the "SEC Exclusion").[9]

A "reliance opinion" is written advice that concludes at a more-likely-than-not confidence level that a "significant" Federal tax issue (that is, an issue as to which the Service would have a "reasonable basis" for a successful challenge[10] and the resolution of which could have a significant impact) would be resolved in the taxpayer's favor. However, if the advice does not relate to a Listed Transaction or a Principal Purpose Transaction, a practitioner may opt-out of providing a reliance opinion by including a banner at the top of the written advice in large bold typeface to the effect that the advice cannot be used for avoiding penalties (the "Not for Penalty Protection Banner").

A "marketed opinion" is written advice if the practitioner "knows or has reason to know" that the advice will be "used or referred to" by someone other than the practitioner or his or her firm in "promoting, marketing or recommending" a "partnership or other entity, investment plan or arrangement" to a taxpayer. A practitioner can opt-out of providing a marketed opinion if the advice does not relate to a Listed Transaction or a Principal Purpose Transaction by including the Not for Penalty Protection Banner and a "Marketing Banner" (to the effect that the advice was written to support the "promotion or marketing" of the transaction

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entrenched. A more limited concept of tax avoidance would not treat a taxpayer as avoiding taxes when the taxpayer takes advantage of the realization and recognition requirements, and other well-established tax law doctrines and provisions. For purposes of this Report, we have assumed that the Service would interpret the December Regulations in a manner consistent with its expansive interpretation of tax "avoidance."

8 Query whether the subsequent written advice must be a covered opinion or may be an opt-out opinion. For example, can an opt-out marketed opinion satisfy the subsequent advice requirement?

9 In Section 10.35(b)(2)(ii)(B), a comma should be inserted after "evasion)" and before "that."

10 Arguably, there are not "significant" Federal tax issues in the case of an opinion that concludes that the taxpayer "should" or "will" prevail.

addressed in the advice and that the taxpayer should seek advice from an independent tax advisor) in large bold typeface at the top of the advice.

Written advice is subject to "conditions of confidentiality" if the practitioner imposes on recipients a limitation on the disclosure of the tax treatment or tax structure of the transaction and the limitation protects the confidentiality of the practitioner's tax strategies. Written advice is subject to "contractual protection" if the taxpayer has the right to a refund of fees if the intended tax consequences from the matters addressed in the written advice are not sustained (or if the fees are contingent on the taxpayer realizing tax benefits).

Section 10.35(c) imposes a host of requirements for covered opinions. Under Section 10.35(c)(1), a practitioner must "use reasonable efforts to identify and ascertain the facts," including facts relating to future events, must not base the opinion on any "unreasonable factual assumptions" (and it is unreasonable under the December Regulations to assume that a transaction has a "business purpose") and must not base the opinion on any "unreasonable factual representations, statements or findings." The opinion must identify all factual assumptions and all factual representations relied upon by the practitioner. Under Section 10.35(c)(2), the opinion must relate the applicable law to the relevant facts, must not contain "internally inconsistent" analyses or conclusions and, with limited exceptions, must not assume the favorable resolution of any significant Federal tax issue. Under Section 10.35(c)(3), with limited exceptions, the opinion must consider "all" significant Federal tax issues and must provide the practitioner's conclusion as to the likelihood of success on the merits with respect to each such issue. In evaluating likelihood of success, the taxpayer must not take into account the possibility that the return will not be audited, that an issue will not be raised on audit or that an issue will be resolved through settlement. Under Section 10.35(c)(4), the opinion must provide the practitioner's overall conclusion as to the matters considered in the covered opinion.

Marketed opinions must reach a conclusion that the taxpayer is more-likely-than-not to prevail. If the practitioner cannot reach that confidence level, the practitioner is prohibited from providing a marketed opinion, but (if the opinion does not relate to a Listed Transaction or a Principal Purpose Transaction) may provide an opinion that contains the Not for Penalty Protection Banner as well as the Marketing Banner.

Despite the general rule in Section 10.35(c) that a practitioner must not assume the favorable resolution of any significant Federal tax issue and must reach a conclusion as to each significant Federal tax issue, under certain circumstances an opinion that considers fewer than all the significant Federal tax issues (a "Limited Scope Opinion") may be given. Limited Scope Opinions are not permitted in respect of Listed Transactions or Principal Purpose Transactions nor is a marketed opinion permitted to be limited scope.

Covered opinions must contain certain disclosures at the top of the written advice in bolded large typeface. Covered opinions must disclose any compensation arrangement or referral agreement between the practitioner and a person, other than the client for whom the opinion is prepared, with respect to promoting, marketing or recommending the arrangement. Marketed opinions must contain the Marketing Banner. Limited Scope Opinions must contain a banner stating that the opinion is limited to the issues addressed, other issues could affect the tax treatment and the opinion cannot be used for penalty protection beyond the scope of what is contained in the opinion. Opinions that fail to reach a more-likely-than-not conclusion must so disclose and state that the opinion cannot be used for the purpose of avoiding penalties. The Regulations preclude a practitioner from providing advice—written or oral—that is contrary to or inconsistent with the above disclosures.

Finally, Section 10.37 contains specific requirements for written advice that is not a covered opinion. In providing written advice that is not a covered opinion but that concerns one or more Federal tax issues (regardless of whether "significant"), a practitioner must not base the advice on unreasonable factual or legal assumptions, unreasonably rely on representations or other statements, fail to consider all relevant facts that the practitioner knows or should know or account for the possibility that a return or issue will not be audited or will be resolved through settlement.

III. <u>Informal Written Advice</u>

As discussed in Section I, we recommend an "opt-in system." Under our Primary Recommendation, no limitations are imposed on an advisor's ability to provide informal written tax advice to clients, unless the advice is a marketing opinion or relates to a Listed Transaction, but a taxpayer may not rely on such advice as reasonable cause for taking a tax position (*i.e.*, to mitigate the risk of imposition of penalties) unless the advice contains an "opt-in" banner. In that event, the advisor must comply with the rules of Section 10.35. If you do not adopt our opt-in suggestion, we recommend, for the reasons set out below, the exclusion of informal written advice from the requirements of Section 10.35.

The elaborate requirements applicable to covered opinions are impractical in the context of the informal advice that practitioners often provide to clients. As a result, those requirements will impede taxpayers from receiving quick informal advice that they require. Such an impediment is undesirable from a tax policy perspective, because quick informal advice facilitates taxpayers' knowledge of and compliance with the tax law. Such advice allows taxpayers to make informed decisions on a "real time" basis.

Prior to the advent of e-mail, informal advice was often provided orally or in short written form. Now, advice that would in the past have been delivered orally is often transmitted by e-mail. E-mail thus serves in many cases as a substitute for oral advice. Like oral communication, e-mail is fast and efficient. In fact, e-mail is often faster and more efficient than oral communication, because the sender and the receiver or receivers need not be present at the same time. The amount of e-mail transmitted by tax practitioners is voluminous. E-mail has become one of the primary means by which many tax practitioners communicate with their clients. We believe that informal e-mails are more akin to oral advice than they are to formal tax opinions. In order to continue to permit taxpayers to receive quick informal tax advice that enhances their understanding of the tax law and ability to comply, we believe that informal advice, such as most e-mails, should be excluded from the concept of "covered opinion."[11]

Consider the following example:

> ***Example 1. Section 338 Election***. Lawyer has advised Client, a group of investors, regarding an acquisition of Target, a Subchapter S corporation

[11] In this Section III, we discuss the overbreadth of the December Regulations in the context of informal advice regarding transactions that may be Significant Purpose Transactions. Sections IV and V, respectively, highlight additional problems that arise from the application of the covered opinion rules to e-mails and other informal advice that may constitute marketed opinions or advice regarding Principal Purpose or Listed Transactions.

> organized in Delaware. Client has formed Purchaser, a Delaware corporation, to make the purchase. The purchase is intended to be a "qualified stock purchase" with respect to which a Section 338 election will be made. Client sends an e-mail to Lawyer: "Lawyer—The largest shareholder in Target would like the opportunity (but not the obligation) to invest in Purchaser at some point after Purchaser acquires Target. Will that have any effect on the basis step-up that we are expecting?" Lawyer responds: "As long as he isn't obligated to reinvest, I believe that should be ok, although the answer isn't entirely clear-cut."

The e-mail from Lawyer, even though it is only one sentence long, might be viewed by the Service as a covered opinion under the December Regulations by reason of being a reliance opinion in connection with a Significant Purpose Transaction. It appears to reach a conclusion stronger than "more likely than not." Although a qualified stock purchase should not be considered a Significant Purpose Transaction, the Service's view of what constitutes a purpose of tax avoidance is very broad.[12] Thus, arguably, in Example 1, the fact that the transaction is intended to result in a step-up in Target's basis in its assets would make it a Significant Purpose Transaction to Client and Purchaser in the Service's view. Further, the Preliminary Advice Exclusion may not apply, because there may be no expectation at the time that the e-mail is written that formal advice on the topic would be expected.

Thus, in Example 1, under the December Regulations, the practitioner would not be permitted to provide the e-mail. Instead, the practitioner has three choices. He or she could (a) provide the advice orally, (b) provide a full-blown opinion satisfying the requirements of Section 10.35 or (c) provide the Not for Penalty Protection Banner at the top of the e-mail. Providing oral advice could result in delay, because the practitioner and the recipient have to be available at the same time. Further, oral advice could be misunderstood or forgotten. Providing a full-blown opinion is certainly not practical as the client needs the advice quickly and may not be inclined to pay for a full-blown opinion.

The Not for Penalty Protection Banner is unwieldy and awkward. Requiring that banner is akin to requiring practitioners to answer the phone or start every oral conversation with the phrase, "You can't rely on what I tell you in this conversation for penalty relief." It disrupts

[12] See note 7 above.

the flow of communication between a practitioner and his or her client. While the banner may be appropriate for formal advice, it is not an appropriate solution for fluid informal communication, such as e-mail. The banner – disconnected as it is from the client's inquiry – is likely to confuse clients who simply asked for tax advice. The banner is unlikely to enhance the public's confidence in the "honesty and integrity" of tax professionals. Instead, by raising the topic of penalties in the context of an informal communication, the banner may seem peculiar, at best, and suspicious, at worst, to taxpayers.[13]

Although the December Regulations aim to deter a relatively narrow category of tax advice, the banner would become a ubiquitous feature of e-mails from tax advisors. This is a heavy-handed and overreaching means of pursuing the goals of the regulations, and we suspect, like most boilerplate, the banner would eventually be ignored.

Consider the following examples as well:

> ***Example 2. Spin-Off***. Lawyer has been advising Client regarding a divisive tax-free reorganization of one of its businesses. Client's in-house tax counsel sends Lawyer the following e-mail, "Lawyer—I know you said that Parent needs to use 100% of the cash it receives from Subsidiary in the reorganization to pay down third-party debt of Parent under Section 361(b)(3) of the Code. Parent plans to invest the $1 million it receives from Subsidiary in certificates of deposit, then six months later, pay $1 million to third-party creditors of Parent, but Parent will keep the interest it earns on the $1 million through the certificate of deposit. Ok?" Lawyer responds, "Your proposal probably works. We should talk."

> ***Example 3. U.S. Shareholder***. Client, and various members of Client's extended family, are considering purchasing the stock of a French corporation that manufactures pharmaceuticals. Client has asked Lawyer to review the proposed acquisition with an eye towards determining whether Client will be a "U.S. shareholder" in a "controlled foreign corporation." Client sends Lawyer an e-mail, "Lawyer—have you reached a conclusion regarding whether I will be a 'U.S. shareholder'?" Client responds, "Yes, based on what we know about the ownership of the company after the acquisition, we believe that you will not be a U.S. shareholder. We would be happy to share our analysis with you if you would like."

13 As the December Regulations are drafted, the e-mail would be subject to Section 10.37 if it contained the Not for Penalty Protection Banner. See Section XI for a discussion of the difficulties of applying Section 10.37.

> ***Example 4. Qualified Dividend Income.*** Client, a U.S. citizen, is an employee of an Italian corporation the stock of which is traded on the New York Stock Exchange. Client e-mails to Lawyer, "My employer is offering me the opportunity to purchase stock. However, they are requiring that I contractually agree not to sell the stock for three years. Will I still be entitled to a 15 percent rate on the dividends if I agree to that?" Lawyer, "Yes, I believe that you will still be entitled to the 15 percent rate. To get that rate, the stock must be 'readily tradable' on a U.S. exchange. But, I believe that that requirement applies based on the class of stock that you own, such that individual contractual arrangements with respect to the stock don't matter."

The examples above arguably are covered opinions under the December Regulations. At the same time, there are arguments that some of them are not covered opinions. Perhaps there is no tax avoidance purpose in Example 4. The Preliminary Advice Exception may apply to Example 2.[14] A taxpayer should not be delayed in receiving tax advice by reason of the tax practitioner having to take the time to evaluate whether he or she is delivering a covered opinion each time that he or she writes an e-mail. Such an evaluation takes precious time and distracts the practitioner from the substantive question that the client has posed. Further, less experienced practitioners (*e.g.*, associates in law firms) will require significant assistance of supervising practitioners (*e.g.*, partners in law firms) in conducting this evaluation. Placing the Not for Penalty Protection Banner at the top of every e-mail would avoid the need to consider whether each e-mail would otherwise constitute a covered opinion (assuming that it is clear that the transaction in question is not a Principal Purpose Transaction or Listed Transaction) but would be an awkward intrusion.

Further, even in the absence of the Not for Penalty Protection Banner, the quick advice provided in short e-mails would not provide penalty protection in most cases. In order for a taxpayer to avoid penalties by reason of having reasonably relied in good faith on advice, the advice must "be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances"[15] and must "not be based on unreasonable factual or legal

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14 Certain informal written advice may not involve a "plan or arrangement" because the client's question may be posed at a time when the client is merely considering a variety of options and does not have any particular plan at the time of the request. See Section IX.

15 Treas. Reg. Section 1.6664-4(c)(1)(i).

assumptions."[16] An informal e-mail is unlikely to satisfy the reasonable reliance test. Indeed, in several cases, a taxpayer's reliance on informal advice has not satisfied this test.[17] Clients desiring tax advice that they can rely on for penalty protection tend to request that the practitioner deliver formal advice in hard copy on the practitioner's firm letterhead.

Although most informal advice nowadays is given via e-mail, there are circumstances under which informal advice is provided in a memorandum. For example, suppose a client requests a memorandum to be provided the following day discussing the tax treatment of a proposed cash distribution from a corporation owned by the client. In light of the time constraints, the memorandum might indicate that it is "preliminary" or that it reflects the practitioner's "initial thoughts" on the matter. There may be no expectation that a formal covered opinion would be given later.

The Preliminary Advice Exclusion is too narrow to alleviate many of the burdens described above. In many cases, informal advice is not expected to be followed by a formal opinion that would meet the standards of Section 10.35. Indeed, in many cases of informal advice, there may be no reasonable expectation of a transaction, much less of a formal opinion with respect to a transaction. In other cases, the client simply does not want to pay for a full-blown opinion. The client may be comfortable proceeding on the basis of advice that has not been exhaustively researched and examined.

The opt-in system of our Primary Recommendation would relieve the concerns described above. If, however, the opt-out approach is retained, we recommend that the December Regulations be amended to exclude informal advice (other than marketed opinions and advice with respect to Listed Transactions) from the concept of "covered opinion." In particular, we would recommend excluding written advice that the intended recipient could not

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16 Treas. Reg. Section 1.6664-4(c)(1)(ii).

17 For example, in *Dwinnell & Co. v. Comm'r*, 33 T.C. 827 (1960), the court held that the taxpayer's casual discussion with his accountant about a tax position on a tax return "in a general way" did not constitute reasonable reliance. Similarly, in *Richardson v. Comm'r*, 125 F.3d 551 (1997), the Seventh Circuit stated that the taxpayer's general consultation with her accountant regarding the preparation of her tax return did not constitute reasonable reliance.

reasonably construe as advice that could be relied upon for avoiding penalties in light of the facts and circumstances, including the sophistication of the client, the relationship and course of dealing between the advisor and the recipient and the context of the written advice.[18] A written communication that expressly indicates that it is "preliminary," "informal" or a practitioner's "initial thoughts" on the matter would generally be excluded from the concept of a "covered opinion." Further, under this approach, we would recommend a safe harbor to the effect that any written advice (other than marketed opinions and advice with respect to Listed Transactions) that includes the Not for Penalty Protection Banner (whether at the top or bottom of, or elsewhere in, the written advice) would satisfy the standard. We expect that you would make it clear in regulations under Sections 6662 and 6664 that such informal advice cannot be relied upon for penalty protection.[19] Under our Primary Recommendation or under the opt-out system of the December Regulations, we recommend that marketed opinions and written advice regarding Listed Transactions, whether formal or informal, be permitted to opt out of covered opinion status with the inclusion of a Not for Penalty Protection Banner as well as a Marketing Banner, in the case of marketed opinions, and a Listed Transaction banner, in the case of advice regarding Listed Transactions.

IV. Marketed Opinions

We wholeheartedly agree with the Treasury's and Service's effort to counteract the use of "one-size-fits all" opinions to facilitate the marketing of tax shelters. We believe that marketing opinions (properly defined) are the type of written communication most vulnerable to the types of abuses that the IRS and Treasury seek to counteract. Accordingly, although we believe that most forms of written communication should be subject to an opt-in regime, we believe that marketing opinions are an exception. We believe that marketing opinions should be subject to an opt-out regime. That is, marketing opinions should either bear the Not for Penalty Protection Banner and the Marketing Banner or they should comply with the requirements for

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18 At a minimum, the various required banners should be permitted to be placed at the bottom of the written advice.

19 The Preamble indicates that the Regulations under Section 6664 will be amended to conform to Circular 230.

covered opinions. We thus support the December Regulations' approach for marketed opinions. Our main concern, however, relates to the overbreadth of the definition of marketed opinion in the December Regulations.

As written, the "marketed opinion" definition includes many forms of written advice that are not used to market tax shelters. The scope of that definition should be narrowed. Properly defining the scope of marketed opinions is important even if our Primary Recommendation of an opt-in system is not adopted, because marketed opinions are subject to special requirements under the December Regulations.[20]

The expansiveness of the definition of "marketed opinion" derives from the breadth of the terms used to define "marketed opinion," specifically, advice that will be "used or referred to" by a person "in promoting, marketing or recommending" a transaction.[21] "Recommending" is a broader concept than "marketing." Business partners frequently "recommend" transactions to each other without becoming tax shelter promoters. Indeed, as businesspeople negotiate over transactions, they "recommend" that their counterparts take part in a transaction. Tax advice that one party has received may be proffered to another as a way of encouraging the second party to agree to a business transaction.[22] Likewise, a corporation may share tax advice that it has received with its shareholders in recommending a transaction. There is a wide scope of business dealings that involve "recommending" that do not fall within the type of tax shelter promotion that is the intended target of the December Regulations.

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[20] All marketed opinions must bear the Marketing Banner. Marketed opinions may not be Limited Scope Opinions. Marketed Opinions must reach a more-likely-than-not conclusion. In order for written advice that would otherwise constitute a marketed opinion to opt-out, the advice must bear both the Not for Penalty Protection Banner and the Marketing Banner. Finally, written advice that would otherwise constitute a marketed opinion but has opted out is subject to a "heightened standard of care" under Section 10.37, because of the "greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances."

[21] We note that the requisite transaction is a "partnership or other entity, investment plan or arrangement." By contrast the concept of Significant Purpose Transaction and Principal Purpose Transaction includes "any other plan or arrangement." We assume that this distinction was intended, that is, that marketed opinions are meant to pick up "investment" plans or arrangements but not "any" plans or arrangements. Nevertheless, the concept of "investment" is sufficiently vague that we believe further clarification of the concept of "marketed opinion" is necessary.

[22] See Example 5 below.

The concept of marketed opinion would be more manageable and more targeted to the type of transactions it is supposed to cover if it was defined as "written advice that the practitioner reasonably expects will be shown by the recipient to a person not affiliated with the recipient for the purpose of promoting or marketing" a transaction. Thus, we recommend that the concepts of "used," "referred to" and "recommending" be eliminated. The concept of "marketing" targets the types of activities that the December Regulations aim to capture.[23] "Marketing" (and "promoting") connote a situation where a tax product is sold to users by intermediaries. The terms connote a situation where tax professionals come up with an idea that is brought to a "market" of non-tax potential users by salespeople flogging the idea.

Similarly, the "referred to" part of the definition seems overbroad. If a practitioner complies with the December Regulations by providing a Marketing Banner whenever he or she believes that the written advice will be "referred to," the intermediary may well not refer to the banner.[24] Further, a mere reference to a tax practitioner's written advice could not be expected to provide penalty protection. We believe that the phrase "shown to" sufficiently captures targeted transactions, and "referred to" sweeps beyond what is intended to be covered.

Several examples demonstrate the overbreadth of the concept of a marketed opinion:

> ***Example 5. Continuity of Interest.*** Lawyer has been advising Acquiror regarding the negotiation of Acquiror's merger with Target throughout the past three months. The merger is intended to qualify as a reorganization of Target into Acquiror under Section 368(a)(1)(A) of the Code. Shortly before the merger agreement is to be signed, Acquiror sends an e-mail to Lawyer that states "Lawyer, Target is skeptical when we say that our proposed consideration of 60%

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[23] Indeed, the December Regulations themselves appear to acknowledge that "recommending" is beyond the appropriate scope of the concept of marketed opinion. The Marketing Banner contained in Section 10.35(b)(5)(ii)(B) and Section 10.35(e)(2)(ii) states that the opinion was written to support the "promotion or marketing" of the transaction, saying nothing about "recommending." The definition of marketed opinion should not sweep more broadly than the Marketing Banner. Cf. Code Section 1258 (certain transactions "marketed or sold" as producing capital gain or loss generate ordinary income).

[24] Note that Section 10.35(e) prohibits "the practitioner" from providing advice inconsistent with a Marketing Banner, but does not prohibit intermediaries from so providing advice.

> stock/40% cash will satisfy the continuity of interest requirement. Could you confirm that this consideration mix will not pose a continuity problem? I would like to forward your e-mail to Target's CEO." Lawyer quickly responds by e-mail, "As we have discussed many times, the consideration mix will satisfy the continuity of interest requirement."

Under the December Regulations as drafted, Lawyer's response could be a marketed opinion. Even though Lawyer's e-mail is only one sentence in length, Lawyer's e-mail is written communication that concerns one or more Federal tax issues arising from a plan that arguably has a significant purpose of tax avoidance (a tax-free reorganization). The fact that the Service has no reasonable basis to challenge the advice does not eliminate the advice from the category of marketed opinion. Unlike reliance opinions, there is no requirement that a marketed opinion provide advice regarding a "significant" tax issue. In the example, Lawyer "has reason to know" that Acquiror will "use" Lawyer's e-mail in "recommending" the acquisition by forwarding the e-mail to Target's CEO. So, Lawyer is confronted with several choices: (a) organize a conference call in which Lawyer is able to speak directly with the CEO of Target, (b) provide a full-blown covered opinion or (c) provide the e-mail with the Marketing Banner and the Not for Penalty Protection Banner. Choices (a) and (b) are impractical. Choice (c) may or may not be practical but is inappropriate. The Marketing Banner—stating that the advice was written to support the "promotion or marketing" of the transaction—would confuse the Acquiror and the Target by implying that the transaction is suspicious. Limiting the concept of "marketed opinion" to advice shown to another person in "marketing" a transaction would address this example because we do not believe that Acquiror's use of the e-mail for the purpose of encouraging Target to participate in the strategic acquisition constitutes "marketing." In addition, excluding advice provided in the context of a strategic acquisition would address this example.

Many written communications, even informal preliminary e-mails, with investment banks are likely to be marketed opinions under the December Regulations.

> ***Example 6. Investment Bank Inquiry Regarding Hybrid Instrument.*** Investment Bank often asks Lawyer tax questions for use in its advice to business clients. Investment Bank sends Lawyer the following message: "Lawyer, Quick question. A client is considering issuing a TOPRS. Interest deductibility is

> important. Could you remind me whether a TOPRS is treated as debt or equity for tax purposes?" Lawyer e-mails Investment Bank, "Debt."

Lawyer's informal communication to Investment Bank could be a marketed opinion. Arguably, Lawyer has reason to know (based on past experience) that Investment Bank will "refer" to, or possibly "use," the advice with one of its clients. Under the December Regulations, Lawyer could (a) provide the advice orally, (b) provide a covered opinion, (c) provide the e-mail with the Not for Penalty Protection and Marketing Banner or (d) perhaps state in the e-mail that the Lawyer's advice should not be "used or referred" to in marketing, promoting or recommending a TOPRS. As before, choices (a) and (b) are impractical. Choice (c) seems futile because Investment Bank may well refer to the advice without referring to the banners. In any event, Investment Bank's client would not be able to rely on Investment Bank's reference to the e-mail to avoid penalties. Perhaps the concern is that Investment Bank might forward the e-mail. Here again it is difficult to see that Investment Bank's client would be able to rely on the e-mail for penalty protection even if it does not contain the banner, because the e-mail does not consider the facts of the specific transaction. If the concern is that Investment Bank would forward the written advice, then the "referred to" language in the definition of "marketed opinion" is overbroad.

Choice (d) highlights a tension in the December Regulations. Choice (d) would likely mean that the e-mail was subject to conditions of confidentiality. Ironically, if a practitioner attempts to avoid having his or her advice be considered a marketed opinion, by limiting the recipient's ability to use or refer to the advice, the advice is likely to wind up in the category of conditions of confidentiality.

We recommend that written advice not be considered a marketed opinion by reason of the taxpayer knowing or having reason to know that the advice may be "referred to." On the other hand, if the taxpayer knows or has reason to know that the written advice itself will be shown to others for the purpose of marketing the transaction, that should be sufficient to make the advice a marketed opinion. For example, we would expect tax disclosure in an offering circular or prospectus to constitute a marketed opinion (although it may be excluded from the definition of a covered opinion under the SEC Exclusion). In the case of written advice intended to be a marketed opinion, the practitioner should be permitted to opt out by providing the Not for Penalty Protection Banner and the Marketing Banner.

Written advice should not be considered a marketed opinion by reason of the recipient sharing the written advice with parties with whom the recipient has a special relationship. For example, spouses, members of an affiliated group, related parties under Section 267 or 707, joint venture partners, parties to a strategic acquisition or parties to a leveraged buyout should be permitted to share advice without the advice being considered a marketed opinion.

> ***Example 7. Spouses***. Shortly before entering into a contract to purchase a house, Husband retains Lawyer for the purpose of answering questions regarding whether he and his spouse may claim home mortgage deductions on their joint Federal income tax return. Husband mentions to Lawyer that he may show Lawyer's written advice to his spouse, Wife. Lawyer mails to Husband a one-page letter addressed to Husband confirming that interest deductions on the mortgage should be deductible.

Arguably, Lawyer's written communication to Husband is a marketed opinion because Lawyer is aware that Husband may use Lawyer's written advice in recommending the home purchase and mortgage to Wife. Lawyer's use of the Marketing Banner—stating that the letter was prepared "to support the promotion or marketing" of the home purchase and mortgage—would likely confuse Husband, who merely requested advice regarding home mortgage deductions.

Members of an Affiliated Group and Related Parties. Written advice should not be considered a marketed opinion by reason of a corporate recipient sharing its tax advisor's advice with a member of its affiliated group. Corporate taxpayers regularly request written advice from practitioners in order to pursue corporate transactions that may involve one of its corporate subsidiaries or its corporate parent. We do not believe that the sharing of written advice by a corporate taxpayer within its affiliated group is the type of activity that the marketed opinion rules should target. Similar arguments apply with respect to taxpayers that bear a Section 267 or Section 707 relationship to one another.

Joint Venture Partners. Written advice should not be considered a marketed opinion by reason of a practitioner having reason to know that the recipient will share such communication with a joint venture partner.

Strategic Acquisition Parties or Leveraged Buyout Parties. Written advice should not be considered a marketed opinion by reason of a recipient of written advice that is a party to a strategic acquisition or a leveraged buyout sharing that written advice with another party to the transaction. In normal strategic acquisitions or leveraged buyouts, parties often share with each other legal advice received from counsel. See Example 5 above. A purchaser may share with the seller written advice from counsel regarding the expected tax treatment of the transaction in order to respond to a question or concern of the seller. Parties to strategic acquisitions and leveraged buyouts regularly use their respective counsel's advice to progress a transaction forward.

General Partner or Management Company of Private Equity Fund. Written advice should not be considered a marketed opinion by reason of a general partner or management company of a private equity fund showing the advice to the fund itself or limited partners in the fund. Private equity funds are vehicles by which investors pool their cash to invest in large stakes in companies. Generally, the goal is to sell these stakes in a number of years. The funds are generally organized as limited partnerships. Limited partners (often tax-exempt entities) provide the capital. The general partner and/or a management company control the decisions of the partnership, while the limited partners are passive investors. Tax advisors typically deal with representatives of the general partner or management company. In some cases, a general partner or management company may wish to show tax advice that it has received to a limited partner or the fund. Despite the fact that the general partner and management company do not bear a Section 267 or 707 relationship to the fund or the other investors, the general partner and management company do exercise control over the affairs of the fund. Advice received by them should be able to be shared without the need for a Marketing Banner and Not for Penalty Protection Banner.

V. **Principal Purpose Transactions.**

The December Regulations provide rules for Principal Purpose Transactions that differ from the rules for Significant Purpose Transactions. Whether our Primary Recommendation of an opt-in system is adopted or the opt-out approach of the December Regulations is retained, we do not believe that there should be rules for Principal Purpose Transactions that differ from the rules for Significant Purpose Transactions. The December Regulations do not provide an opt-out for written advice regarding a Principal Purpose Transaction. The Not for Penalty Protection Banner will not remove written advice regarding a Principal Purpose Transaction from the category of a covered opinion. Further, Limited Scope Opinions are prohibited with respect to a Principal Purpose Transaction. As a result, under the December Regulations, any written advice, regardless of its purpose or use, that concerns a Principal Purpose Transaction, must be given in the form of a full-blown opinion that satisfies all of the covered opinion standards. The absence of an opt-out for advice concerning Principal Purpose Transactions creates a blanket prohibition against any short-form written advice with respect to such transactions.

This is problematic for several reasons. First, the lack of an opt out for Principal Purpose Transactions will impede taxpayers from receiving written advice in connection with such transactions. In some cases, taxpayers will choose to proceed without any written advice at all, because the regulations polarize a taxpayer's choice between oral advice and a formal full-blown opinion. In other cases, a covered opinion satisfying Section 10.35 would not even be possible, because the facts of the transaction have not sufficiently developed. Second, it is often very difficult to distinguish Significant Purpose Transactions and Principal Purpose Transactions. Yet, important consequences turn on the distinction.

We do not believe that it is appropriate to impose a blanket prohibition on short-form written advice with respect to Principal Purpose Transactions. Apparently, the reason behind this prohibition is to protect taxpayers by ensuring that they have a full analysis of the tax law and the attendant risks before proceeding with what can be characterized as a relatively aggressive transaction. However, the reality of the business world is that taxpayers need to make quick determinations about transactions on a regular basis and they cannot always wait for, and are not always willing to pay for, a full-blown covered opinion before they make such determinations. Thus, in situations involving relatively aggressive transactions, just when they need the guidance of a professional tax advisor the most, taxpayers will be forced, or will choose, to make decisions without written advice.

> ***Example 8*. *Dividends Received Deduction.*** Lawyer has advised Client, a Delaware corporation, for years regarding corporate transactions. Client sends Lawyer the following e-mail: "Lawyer – Quick question, if we own stock in a corporation and a large number of options to purchase stock in that corporation, and the corporation redeems all of our stock (but we still hold the options), is it possible that we would receive dividend treatment on the redemption (qualifying for the DRD)?" Lawyer responds by e-mail, "Obviously I need more facts to reach a firm conclusion, but generally, when a person owns an option to purchase stock, the tax law treats the person as owning the stock for purposes of testing a redemption. So in a situation where you owned enough options, you would qualify for dividend treatment (and the DRD) when the corporation redeems your stock. However, there would be collateral consequences, including possible gain recognition, under the extraordinary dividend rules of Section 1059 which we need to discuss."

In this example, if the Client is simply looking for the least expensive way to take money out of the corporation, the principal purpose of the redemption arguably is the avoidance of Federal income taxes. In such case, the Lawyer will be prohibited from sending the e-mail. It does not follow, however, that the Client will choose to wait and pay for a full-blown covered opinion. Instead, the Client may well choose to proceed with the redemption based on a conversation with the lawyer in which the lawyer orally describes the rules regarding redemptions, the dividends received deduction and extraordinary dividends. The client may then communicate his understanding of those rules to others in his organization and ultimately a decision may be made without any written advice.

Many client inquiries on complex tax issues could be viewed as relating to Principal Purpose Transactions, yet a full-blown covered opinion would be impossible to write, because the facts have not yet developed. Indeed, the inquiry may well be posed as a short hypothetical fact pattern in order to highlight the legal issue. There may or may not be an actual transaction contemplated. For example: "Does the following technique work under Section 956 to pull up foreign tax credits?"; "What pools of foreign earnings and profits are brought up in what order in a Section 304 transaction?"; and "How do the Section 959 ordering rules apply?". Arguably, these questions all relate to Principal Purpose Transactions. If so, the practitioner is not permitted to provide short form written advice in response.

The absolute prohibition against short written advice regarding Principal Purpose Transactions may even prevent a practitioner from advising a client in an e-mail or other short-form writing that a defective transaction does not work. Suppose the client in Example 8 above intended to hold only a few options yet wanted the redemption of stock to be treated as a dividend. The lawyer would be prohibited from sending a quick e-mail stating that the transaction will not work as anticipated. In cases where the client's tax structure is flawed, the client has an even greater need for quick written advice during the initial planning stages of the transaction that outlines the potential risks and pitfalls so that the taxpayer can decide on a timely basis to modify or abandon the transaction. Nevertheless, the December Regulations prohibit a practitioner from sending a quick e-mail stating that the transaction as structured does not work. Along the same lines, in the case of a Principal Purpose Transaction, it may be particularly important to tell a client that a transaction will only work if it has a business purpose. Yet, this succinct advice appears to be prohibited by the December Regulations.

The problem created by the December Regulations' treatment of Principal Purpose Transactions is compounded further by the requirement that a practitioner be "knowledgeable in all of the aspects of Federal tax law" relevant to the opinion. It seems that written advice regarding a Principal Purpose Transaction cannot be given without the practitioner researching all the issues before sending an e-mail. For example, suppose a taxpayer sends an e-mail, "I'm considering engaging in a swap under which I may receive a contingent payment at the end. Will I be permitted to defer inclusion of that amount until I receive it?" If the transaction is a Principal Purpose Transaction, a practitioner would not be permitted to write back "I'm researching the issue but I believe so."

Situations like this will play themselves out on a regular basis. Under the December Regulations, taxpayers evaluating Principal Purpose Transactions would be forced to choose between waiting and paying for full-blown opinions or proceeding based on oral conversations. We believe that the blanket prohibition against any quick, short-form written advice relating to Principal Purpose Transactions will lead to more reliance on oral advice in precisely those situations involving the most aggressive or complex planning. This will serve to increase, not decrease, the possibility that taxpayers will become confused or fail to understand the tax risks involved.

Further, by creating different rules for Principal Purpose Transactions and Significant Purpose Transactions, the December Regulations force practitioners to determine whether reduction of taxes is the principal purpose, or only a significant purpose, of a given transaction. This determination is extremely difficult to make and it is not practical to require practitioners to make the determination every time they are about to give written advice.

Almost all advice rendered by a tax practitioner concerns, in one way or another, the reduction of taxes.[25] The distinction between a tax reduction purpose that is the principal purpose, as opposed to just a significant purpose, of a transaction is notoriously ambiguous.[26] Treas. Reg. Sec. 1.6662-4(g)(2)(i)(C) provides that a purpose is "the principal purpose" if it "exceeds any other purpose". This definition provides little guidance. A practitioner will be required to determine all the possible purposes or motivations behind a transaction and evaluate the relative weight or importance of those purposes from the taxpayer's perspective. To the extent that the motivations behind a transaction are subjective, the same transaction may constitute a Principal Purpose Transaction in one situation and a Significant Purpose Transaction in another situation. Or, the purposes motivating a transaction may change over time. In many circumstances, it will be nearly impossible for a practitioner to distinguish between the various purposes and determine which written advice standards apply to the requested advice.

> ***Example 9. Thinly-Capitalized Entity.*** Client requests Lawyer to review and provide written comments on a term sheet for a possible transaction. The term sheet involves the creation of a thinly capitalized entity that is funded by a loan

[25] See note 7 above.

[26] Another ambiguity in the December Regulations concerns the question of what the entity, plan or arrangement is for which the various purposes are being evaluated. Does the practitioner look to the overall plan or arrangement, such as the entire reorganization, or just one aspect of the overall plan or arrangement, such as the creation or liquidation of an intermediate subsidiary? In some cases, the way in which the phrase, "entity, plan or arrangement" is interpreted will determine whether a purpose is the principal purpose or just a significant purpose behind the "entity, plan or arrangement."

from a joint venture partner. The practitioner will want to comment on whether money contributed constitutes debt or equity. Before shooting off an e-mail or jotting down a few notes on the difference between debt and equity and some factors the client should keep in mind when discussing the transaction, under the December Regulations, the practitioner will first have to evaluate the purpose behind the transaction and the role that any potential interest deduction on the debt payments will play in the overall structure. As part of that evaluation, the practitioner may have to interview the potential joint venture partners to determine their particular tax situations and their subjective purposes for making the investment and structuring it as debt. To complicate matters further, it is possible to envision a scenario in which, during the course of negotiations, the interest deduction on the debt changes from being just a significant purpose to the principal purpose behind the particular form of the transaction that is chosen.

Despite the inherent ambiguity involved in distinguishing among a taxpayer's purposes for a transaction, the December Regulations make the distinction critical by permitting a Not for Penalty Protection Banner opt-out for Significant Purpose Transactions but not for Principal Purpose Transactions. Further complicating matters, the distinction will have to be made on the spur of the moment on a daily basis. Moreover, in law firms, e-mails are sent by junior tax lawyers as well as senior tax partners. Even these junior tax lawyers will be forced to engage in a principal versus significant purpose analysis before they send every e-mail. Under these circumstances, it will be extremely difficult and burdensome for the practitioner to comply with the different opinion standards set forth in Section 10.35.

Thus, too much hangs on the distinction between "a significant purpose" and "the principal purpose", which is itself ephemeral. In light of the foregoing problems, we recommend that written advice regarding Principal Purpose Transactions or Significant Purpose Transactions be treated the same. Under our recommended opt-in approach, all such advice should be ineligible to serve as penalty protection unless it states that it is so eligible and complies with the requirements for covered opinions.

If the opt-out approach of the December Regulations is retained, then the distinction between Principal Purpose Transactions and Significant Purpose Transactions should be eliminated. In that event, written advice that constitutes a reliance opinion, marketed opinion, advice subject to conditions of confidentiality or advice subject to contractual protection would be a covered opinion regardless of whether it related to a Principal Purpose Transaction or a

Significant Purpose Transaction. The Not for Penalty Protection Banner would have the same effect—*i.e.*, excluding the advice from reliance opinion status and, together with the Marketing Banner, from marketed opinion status—regardless of the type of transaction involved. By the same token, Limited Scope Opinions should be allowed to be given with respect to Principal Purpose Transactions.

VI. <u>Listed Transactions.</u>

The December Regulations provide that all written advice regarding a Listed Transaction is a covered opinion. A practitioner may not opt out of the covered opinion requirements by including a Not For Penalty Protection banner and there are no circumstances in which a practitioner can give a limited scope opinion with respect to a Listed Transaction.

We realize that Listed Transactions are the most aggressive category of transactions defined in Section 10.35(b)(2)(i). However, while Treasury may frown on such transactions, taxpayers are not prohibited from entering into Listed Transactions and, in a few cases, courts have upheld the taxpayer's claimed benefits arising from a Listed Transaction. Further, precisely because these types of transactions are relatively aggressive, these are the very situations in which the taxpayer may require quick and inexpensive advice, particularly if the client is not aware of the Service's view of such a transaction. The result of the absolute prohibition against written advice regarding Listed Transactions is that the December Regulations may not even allow a practitioner to advise a client in a short-form writing that a defective transaction does not work.

To take an obvious example, suppose that Client sends Lawyer an e-mail message that asks, "Lawyer, Is it true that I can no longer conduct a 'Son of BOSS' transaction without encountering problems from the IRS?" Lawyer is arguably prohibited from responding to Client by e-mail stating "Yes, your understanding is correct. The IRS now considers Son of BOSS a 'listed transaction' (a.k.a., tax shelter!)." Without such written advice from practitioners, clients may make uninformed decisions to engage in abusive transactions.

Consider the following more subtle example in which a taxpayer's limited budget and resources lead him to proceed with an aggressive transaction without any written advice:

> ***Example 10. Coltec***. Client e-mails lawyer and says "I just read the Court of Federal Claims decision in *Coltec Industries, Inc. v. United States*. We have some relatively small contingent liabilities that we would like to contribute to a special purpose subsidiary. Will we be able to later sell the subsidiary and recognize a loss?" Lawyer e-mails back stating "I can't communicate with you via e-mail about this. Let's talk." After a conversation in which Lawyer explains some of the issues and offers to provide a full opinion, Client chooses not to wait and pay for the opinion and decides to go forward based on the conversation and his review of the Court's decision in *Coltec*.

We believe that practitioners should be permitted to provide short-form written advice regarding Listed Transactions under specified circumstances. Under our approach, all written advice regarding a Listed Transaction would constitute a covered opinion in the first instance. However, practitioners would be permitted to opt-out of covered opinion status and deliver written advice about a Listed Transaction that does not meet the standards described in Section 10.35 as long as the advice bears the Not for Penalty Protection Banner and a banner declaring that the advice relates to a Listed Transaction (and, if appropriate, the Marketing Banner). Second, practitioners should be permitted to provide a Limited Scope Opinion with respect to a Listed Transaction as long as the conditions of Section 10.35(c)(3)(v)(A)(1) and (3) are satisfied.

VII. SEC Exclusion

The SEC Exclusion excludes from the concept of covered opinion written advice (other than advice regarding a Principal Purpose Transaction or a Listed Transaction) that is "included" in documents required to be filed with the SEC.

First, we recommend that not only written advice that is "included," but also written advice that is "described" or "summarized" in any document filed with the SEC should be considered excluded advice. For example, parties to a corporate merger may agree in the merger agreement that tax opinions addressed to the target and the acquiror will serve as closing conditions to the merger. The parties may describe in the proxy statement filed with the SEC that such opinions are anticipated to be provided, but may not include a copy of the opinions themselves in any SEC filing. Because the conclusions of the anticipated opinion will be included in such a filing, the opinion should qualify for the exemption. Under our Primary

Recommendation, such an opinion should be permitted to be relied upon for penalty protection by the party to whom it is addressed (the target or the acquiror) if it states that it is intended for such purpose. Under our Primary Recommendation or under the opt-out approach of the December Regulations, the opinion should not be required to comply with all the requirements of Section 10.35. Further, the opinion given to the target or acquiror, addressed as it is to the taxpayer to whom it is directed, should not be required to bear the Marketing Banner.

Second, because of the difficulty in determining whether a transaction has a significant purpose or the principal purpose of tax avoidance as discussed above in Section V, the SEC Exclusion should cover Principal Purpose Transactions, as well as Significant Purpose Transactions.

Third, we believe that the SEC Exclusion does not need to be expanded to cover written advice that is given in connection with offerings of securities that are not filed with the SEC provided that our recommendation is adopted to the effect that written advice with respect to Principal Purpose Transactions is subject to the same rules as those applicable to Significant Purpose Transactions.[27]

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[27] The most common types of securities offerings that are not required to be registered with the SEC are:

Rule 144A Private Placements. A Rule 144A private placement is a private offering of securities made to a Qualified Institutional Buyer (as defined under Rule 144A of the Securities Act of 1933) (generally, a Qualified Institutional Buyer is an entity (such as an insurance company) that in the aggregate owns or invests on a discretionary basis at least $100 million ($10 million for registered dealers) in securities of unaffiliated companies). As a matter of practice, the large and sophisticated institutions that qualify as Qualified Institutional Buyers generally require issuers to prepare an offering memorandum or prospectus that is almost as broad in scope as one that is filed with the SEC.

Offerings under the Private Offering Exemption. The Securities Exchange Act of 1934 exempts from registration "transactions by an issuer not involving any public offering." Section 4(2) of the Securities Exchange Act of 1934. To qualify for this exemption, the purchasers of the securities must (a) have enough knowledge and experience in finance and business matters to evaluate the risks and merits of the investment, or be able to bear the investment's economic risk; (b) have access to the type of information normally provided in a prospectus; and (c) agree not to resell or distribute the securities to the public.

Regulation D Offerings. Regulation D of the Securities Act of 1933 allows companies to offer and sell their securities without having to register them with the SEC. Companies exempt from SEC registration requirements under Rule 506 of Regulation D, may sell securities to an unlimited number of "accredited investors" and up to 35 other purchasers. These companies may not, however, use general solicitation or advertising to market the securities. Purchasers of securities in these offerings receive restricted securities that may not be sold for at least a year without being registered.

Offering memoranda for securities (whether filed with the SEC or not) normally contain a section disclosing the tax consequences of owning the securities. While such disclosure could be considered a marketed opinion (under the December Regulations or under the definition we recommend), it would not be practical for such memoranda to include full-blown covered opinions. Investors are not interested in the extensive analysis required of a covered opinion. Whether the disclosure relates to a Significant Purpose Transaction or a Principal Purpose Transaction, it should not be required to comply with Section 10.35. The approach that we believe balances the competing concerns best is to permit Principal Purpose Transactions to qualify for the SEC Exclusion and to permit the Not for Penalty Protection Banner opt-out for Principal Purpose Transactions.

An argument could be made for expansion of the SEC Exclusion to cover offering memoranda that are exempt from SEC filing. In general, the issuer's liability for misleading disclosures under these types of documents is the same as it is for SEC-filed documents. Written advice included in non-registered offerings is subject to the anti-fraud provisions of the Federal securities laws[28] and may result in liability to the issuer. However, we recognize that offering memoranda that are not required to be filed with the SEC could potentially be used in some cases to market tax shelters. Further, we do not believe that a blanket exclusion for offering documents that are exempt from SEC filing requirements is necessary to strike a practical balance. Tax disclosure in offering memoranda not filed with the SEC could, as a practical matter, contain a Not for Penalty Protection Banner (and a Marketing Banner). Indeed, most tax disclosure in securities offerings already urges investors to consult their own tax advisors and states that it does not address individual circumstances. Thus, even today, such tax disclosure is unlikely to satisfy the minimum requirements for penalty protection. Current practice could be adapted to include the banners contemplated by the December Regulations.

Regulation S Offerings. Offerings that are deemed not to occur within the United States are not required to be registered with the SEC. The applicable rules contain holding period and resale requirements that are intended to prevent "flowback" of the offered securities offered into the United States.

[28] For example, *see* Rule 144A of the Securities Act of 1933, Preliminary Note 1.

Fourth, the Service should confirm that limitations on disclosure imposed by securities laws do not constitute the type of conditions of confidentiality that results in a covered opinion under Section 10.35(b)(6). Many types of securities offerings that are not filed with the SEC are confidential as a result of state or federal (or even foreign) securities laws. The disclosure limitations are not imposed by the practitioner. Accordingly, we believe that such restrictions on disclosure do not result in conditions of confidentiality under the December Regulations. Our decision not to recommend an expansion of the SEC Exclusion to cover advice contained in documents that are exempt from SEC filing hinges on the ability to opt-out of covered opinion status. Because 10.35(b)(6) does not contain an opt-out, it is important that limitations imposed by securities laws not be considered the type of disclosure limitation that would bring written advice within the ambit of the covered opinion concept.

VIII. Limited Scope Opinions

The concept of a Limited Scope Opinion should be clarified or eliminated; if it is retained, more types of Limited Scope Opinions should be permitted.

The concept of a Limited Scope Opinion is unclear.

> ***Example 11. Section 163(l)***. Taxpayer intends to issue a debt instrument that has a variety of equity characteristics. Taxpayer requests that Lawyer provide a formal written opinion that Section 163(l) should not prevent deductibility of interest on the instrument. Lawyer is prepared to deliver such opinion.

We believe that Taxpayer should be entitled to receive the opinion. However, arguably, the issuance of the debt instrument is a Principal Purpose Transaction. If so, a Limited Scope Opinion is prohibited under the December Regulations. It is unclear whether the opinion is limited scope. It reaches a conclusion regarding the application of Section 163(l) to the interest expense. However, it does not conclude that the interest is deductible under the Internal Revenue Code. For example, the opinion does not discuss Section 163(f), Section 163(i), Section 263(g) or Section 482. If the practitioner were confident that the transaction were a Significant Purpose Transaction, then, under the December Regulations, he or she could include the Limited Scope Banner in the written advice. However, as discussed, it is difficult to distinguish between Significant Purpose Transactions and Principal Purpose Transactions.

The concept of Limited Scope Opinion should be clarified. In our experience, most formal opinions address the applicability of a particular Code section, or even subsection. For example, "the merger will qualify as a reorganization under Section 368 of the Code"; "Section 355(e) should not apply." It is rarely the case that formal opinions address all possible theories under which gain or income may be recognized or losses or deductions disallowed. Thus, if the concept of Limited Scope Opinion means opinions that fail to reach these kinds of ultimate conclusions, then most formal written advice will be limited scope and would be forced, under the December Regulations, to contain the Limited Scope Banner. The Limited Scope Banner would become ubiquitous and redundant.

While we recognize that the purpose of the rules regarding Limited Scope Opinions is to protect taxpayers against tax shelter promoters who hide the limited scope of an opinion, we believe that the concept of Limited Scope Opinion is not well-defined and that the rules are likely to be more burdensome than effective. Consideration should be given to eliminating the concept altogether. If it is retained, we believe that Limited Scope Opinions should be permitted in the case of all covered opinions that bear a Limited Scope Banner (whether the advice relates to a Principal Purpose Transaction,[29] a marketed opinion, a Listed Transaction[30] or otherwise).[31]

IX. <u>Hypothetical Transactions</u>

Section 10.35(b)(2) of the December Regulations refers to any written tax advice arising from (a) a "transaction" that is the same or substantially similar to a listed transaction; and (b) "any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement" the principal or a significant purpose of which is the avoidance or evasion of any tax. It is not clear from this language whether the December Regulations were intended to apply to hypothetical transactions. If a taxpayer requests advice regarding a hypothetical transaction, the December Regulations arguably do not apply because there is no actual transaction, plan or

[29] See Section V.

[30] See Section VI.

[31] See Section X.

arrangement that is being considered. However, section 10.35(c)(1)(i) creates some ambiguity on this point because it refers to a practitioner's obligation to identify and ascertain facts which may relate to future events if a transaction is prospective or proposed.

Astute taxpayers will frequently consult with tax advisors about an idea for a transaction even though the actual structure of, or facts regarding, the transaction are fluid and have not yet been determined. Indeed, the advice requested by the taxpayer may be nothing more than a discussion about an idea. In such cases, it would be difficult, or impossible, for a practitioner to identify and ascertain the actual facts because the facts do not exist at the time the advice is given. Similarly, the requirements that practitioners avoid making unreasonable factual assumptions and avoid relying on unreasonable factual representations, statements or findings are also difficult to apply in the context of a hypothetical transaction.[32]

In light of the ambiguity described above, the December Regulations should clarify whether, when and how they apply to written advice regarding hypothetical transactions. If the December Regulations do apply, they should provide clear examples of the point at which such written advice rises to the level of a covered opinion. We recognize that striking an appropriate balance is difficult, because tax shelter promoters may mislead unsuspecting taxpayers by providing opinions based on hypothetical facts.

X. Requirements Applicable to Covered Opinions

First, we have a general concern that Section 10.35(c) appears to refer to an "opinion" (meaning any written advice) as if a practitioner's opinion or advice is always set forth in a single, comprehensive document. That is not necessarily the case. The reality of everyday tax practice is that practitioners communicate with taxpayers in stages over a period of time. It is not uncommon for a practitioner to provide written advice to a client in one form, such as a letter or e-mail, and then follow-up with additional advice with further letters, e-mails or facsimiles. One common example is when an opinion regarding a transaction is given and just before the

[32] At the very least, we recommend that the regulations state that, in situations involving hypothetical or proposed facts, it is reasonable for the practitioner to rely on factual representations provided by the taxpayer provided that the practitioner is not aware of any actual facts that are inconsistent with such representations.

transaction closes, the taxpayer calls or e-mails the practitioner and explains that the facts have changed slightly and wants to know if the new facts change the opinion. The practitioner may need to provide, on short notice, an e-mail or a memo stating that the opinion still holds or explaining how the new facts affect the opinion. In such cases, the follow-up writing should not be required to conform to all the requirements in Section 10.35(c).

The problem is addressed in part by the Preliminary Advice Exclusion. However, under the December Regulations, if no formal opinion is anticipated, then the prior writings must satisfy all of the opinion standards. Even if a formal opinion is anticipated, the prior writings must still satisfy the standards set forth in Section 10.37. In such cases, we believe that it is appropriate, and necessary to avoid imposing undue restrictions on the relationship between the practitioner and the client, to confirm that all related communications between the practitioner and the client must be considered in determining whether the opinion standards in Section 10.35 and the standards in Section 10.37 have been satisfied.

We are also concerned about the prohibition against internally inconsistent legal analyses or conclusions set forth in Section 10.35(c)(2)(iii). Taxpayers should be permitted to obtain from practitioners a complete analysis of a given tax issue. In some situations, the state of the law is so complex that it may be appropriate for written advice to discuss alternative theories or conclusions. Such discussions should not be prohibited as long as at least one analysis or conclusion supporting the taxpayer's position satisfies the requirements of Section 10.35. Further, in some cases, more than one factual scenario is reasonably possible. In such cases, taxpayers should be permitted to obtain an alternative analysis of each possible factual scenario in a single written document even if the alternative analyses are inconsistent with each other.

We believe that a correction should be made to clarify that Sections 10.35(c)(1) and (2) apply only to facts and law relevant to "significant" Federal tax issues. Section 10.35(c)(3) requires that an opinion consider the "significant" Federal tax issues. However, as currently drafted, the December Regulations provide that a practitioner drafting a covered opinion must use reasonable efforts to "identify and ascertain the facts . . . and to determine which facts are relevant"[33] and relate the "applicable law . . . to the relevant facts."[34] Thus, it is not clear whether an opinion must consider and discuss the facts and law relevant to all Federal tax issues, or only the facts and law relevant to significant Federal tax issues. We believe that there is no reason for written advice to address facts and law that do not relate to significant issues (i.e. where the IRS has no reasonable basis for a successful challenge) and that the purposes of Circular 230 are served by requiring written advice to discuss only the facts and law that relate to significant Federal tax issues.

We are troubled by the prohibition against any discussion of the possibility that an issue will be resolved through settlement. This prohibition is set forth in Section 10.37 as well as Section 10.35(c)(3)(iii), so it is an absolute prohibition that applies to any written advice concerning a Federal tax issue regardless of whether the written advice constitutes a covered opinion. While we can understand a prohibition against written advice evaluating whether a return will be audited, we believe that a practitioner should not be prohibited from addressing the possibility that an issue, once raised, will be resolved through settlement.

The tax law is often not black and white and many tax issues are not clearly right or wrong. Indeed, most tax issues, once raised, are resolved through settlement at audit, on appeals or during litigation. A settlement of a tax issue is usually reached through negotiation that takes into account the relative strengths and weaknesses of the parties' positions. Much of what a tax practitioner does is to evaluate the relative strengths and weaknesses of a particular issue.[35] There is no reason a tax practitioner should be prohibited from commenting in writing on how an issue may be resolved during this phase of the tax determination process.

The prohibition on written advice regarding whether an issue will be raised on audit also sweeps too widely. We agree that written advice should not be so provided if the basis for the advice is that the Service will not know the relevant facts. However, sometimes, even if

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33 Circular 230, Section 10.35(c)(1)(i).

34 Circular 230, Section 10.35(c)(2)(i).

35 Such evaluations can be important in determining whether a taxpayer should proceed with a transaction, whether the parties should negotiate an indemnity for latent tax liabilities and whether a tax contest provision is required as part of a transaction.

the Service knew all the relevant facts, an issue may not be one that the Service would be likely to raise on audit. For example, a complicated recast of a transaction under the step transaction doctrine may be too esoteric to be a practical concern. Other issues may not be raised because they would be against the Service's overall interest, even though in the taxpayer's particular case, the Service might be served by raising the issue. Analyses of these types should not be relegated to the domain of oral advice.

XI. Requirements Applicable to Written Advice that is Not a Covered Opinion

Section 10.37 applies to all written advice and appears to incorporate many of the standards set forth in Section 10.35(c). While we understand and agree with the Service's desire to regulate tax advice that can provide penalty protection or that is used to market transactions, we do not believe it is desirable for Treasury to regulate all written advice provided by tax practitioners by prescribing rules, the violation of which could subject the practitioner to sanction (other than rules relating to negligent or fraudulent behavior). We believe that Section 10.37 would deter practitioners from giving written tax advice that is helpful to the proper functioning of the tax system. We are not aware of any other context in which a professional's written advice to a client is so closely regulated.[36]

Under Section 10.37, a tax practitioner is prohibited from giving written advice that is based on unreasonable assumptions, that unreasonably relies on information from others, or that does not consider all the relevant facts that the practitioner knows or should know.[37] In addition, there is a prohibition against accounting for the possibility that a return or issue will not be audited or of a resolution through settlement. The regulations state that "[a]ll facts and circumstances, including the scope of the engagement and specificity of the advice sought" are to be considered in determining whether a practitioner has complied. Pursuant to Section 10.52(a),

36 Section 10.50 already polices the general conduct of practitioners by giving Treasury the authority to impose sanctions on any practitioner shown to be incompetent or disreputable. Thus, the more specific rules set forth in Section 10.37 are not necessary.

37 Query whether these requirements incorporate the requirement in Section 10.35(c)(1)(i) to use reasonable efforts to identify and ascertain facts and determine which ones are relevant.

a tax practitioner is subject to sanction if he or she willfully, recklessly or through gross incompetence violates Section 10.37.

We believe that the standards of Section 10.37 are too vague to support the imposition of sanctions. The trigger for the imposition of sanctions under Section 10.37 is a reasonableness standard which is too ambiguous to be applied to an activity as common and routine as the rendering of written advice by tax practitioners. One interpretation of Section 10.37 would be that a quick request by a taxpayer is satisfied by a quick informal response from an advisor. The lawyer acts reasonably by responding based on what he or she knows at the time without the need for further inquiry or critical examination of implicit or explicit assumptions. Under this loose interpretation of Section 10.37, only the most egregious forms of conduct are prohibited.

However, it is also possible to interpret Section 10.37 more strictly. Under this interpretation, Section 10.37 demands that a practitioner make inquiries and challenge assumptions that he or she would not otherwise do. Indeed, Section 10.37 incorporates many of the standards for covered opinions set forth in Section 10.35(c) implying that quick informal advice that would be subject to Section 10.37 must meet a higher standard than applies in the absence of Section 10.37.[38] Thus, under this interpretation of Section 10.37, a tax practitioner may be forced to run the Section 10.37 analysis numerous times a day with different results. What is reasonable in one situation may well be unreasonable in another situation. Tax practitioners would have to be on guard every time they commit something to writing to ensure that they have not made an inappropriate assumption involving a complex legal or factual issue, or improperly relied on a statement from an impatient or demanding client, or overlooked an area of factual inquiry. The minimum standards set forth in Section 10.37, thus, could be interpreted to prohibit many short-form types of advice that clients want and need in the ordinary course of their business.

Because the demands of Section 10.37 are unclear, some practitioners may refrain from providing quick written advice, primarily in the format of e-mails. As discussed above in Section III, we believe that taxpayers and the tax system are not well-served by the imposition of deterrents to quick informal advice.[39]

The following example demonstrates another ambiguity in Section 10.37, namely, what counts as an "assumption":

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[38] For example, the requirement in Section 10.37 that a practitioner consider all relevant facts that a practitioner knows or should know tracks Section 10.35(c)(1)(i) which requires a practitioner to use reasonable efforts to identify and ascertain all facts (including future facts), determine which are relevant and then consider all such relevant facts. The requirement in Section 10.37 that prohibits any written advice based on unreasonable factual assumptions (including assumptions as to future events) exactly tracks the language of Section 10.35(c)(1)(ii). Likewise, the requirement in Section 10.37 that prohibits unreasonable reliance on representations, statements, findings or agreements of the taxpayer or any other person exactly tracks the language of Section 10.35(c)(1)(iii). As a result, Section 10.37 simply restates almost every standard set forth in Section 10.35(c)(1) relating to factual matters.

Further, the language in Section 10.37 that prohibits unreasonable legal assumptions incorporates the concept set forth in Section 10.35(c)(2)(ii) which likewise prohibits unreasonable legal assumptions and appears to define unreasonable assumptions to include an assumption that a significant Federal tax issue will be favorably resolved. Finally, the requirement in Section 10.37 that prohibits advice that accounts for the possibility that a return or issue will not be audited or resolved through settlement exactly tracks the language of Section 10.35(c)(3)(iii).

The only standards for covered opinions that are not incorporated into Section 10.37 are the standards that require an opinion to (1) relate the law to the relevant facts (Section 10.35(c)(2)(i)); (2) prohibit internally inconsistent analyses or conclusions (Sections 10.35(c)(2)(iii)); (3) consider and provide a conclusion for each significant Federal tax issue (Sections 10.35(c)(3)(i) and (ii)); and (4) provide an overall conclusion as to the tax treatment of the transaction or state why such a conclusion cannot be reached (Section 10.35(c)(4)).

[39] See Section XI regarding the prohibition in Section 10.37 on written advice regarding settlement.

> ***Example 12. Quick Advice that Assumes a Business Purpose.*** Client e-mails a question to Lawyer asking if she can spin-off a subsidiary to the parent's shareholders. Lawyer wants to send an e-mail stating that a spin-off may be possible "assuming" that there is a business purpose. Is the e-mail prohibited under Section 10.37? Arguably, Lawyer has assumed a business purpose, an assumption that Section 10.35(c)(1)(ii) states is unreasonable. However, arguably, Lawyer has not assumed a business purpose, but merely stated that a business purpose is a requirement. Because of this ambiguity, Lawyer refrains from sending the e-mail. Instead, Lawyer, understanding that Client just wants some quick advice as opposed to a full blown opinion, is forced to trade calls with Client over the next several days so that Lawyer can provide the advice orally. In the meantime, Client is left wondering whether the spin-off is a viable possibility and, if so, what the requirements would be.

It is also unclear to us what the "heightened standard of care" applicable to written advice that would be a marketed opinion but for an opt-out is intended to mean.

Because Section 10.37 is open to such a wide range of interpretation, Section 10.37 is too vague to support the imposition of sanctions. The tax law is particularly complex and that complexity is only increased by the need to apply the tax law to an ever-changing and evolving universe of business structures that are developed by clients, often in response to the tax law itself. Written advice assists taxpayers in understanding the myriad of details and nuances involved in tax planning. Section 10.37 impedes the ability of taxpayers to receive such advice. We believe that Section 10.37 should be eliminated.

XII. <u>Conclusion</u>

As written, the December Regulations impede taxpayers from obtaining timely written advice. We believe that such advice, on the whole, enhances voluntary compliance with the tax laws. Accordingly, we believe that the December Regulations impose undesirable burdens on the relationship between a taxpayer and the taxpayer's advisor. Our Primary Recommendation is that the opt-out approach of the December Regulations be abandoned in favor of an opt-in regime for written advice other than marketed opinions and listed transactions, the latter being subject to an opt-out regime. In the event that our Primary Recommendation is not adopted, we respectfully submit recommendations in order to make the December Regulations operate in a more practical fashion.

We also note that the December Regulations significantly alter the ground rules for demonstrating reasonable reliance on advice in order to avoid penalties. A consequence of the December Regulations is that, with few exceptions, the only written advice that taxpayers may rely upon to avoid penalties is a detailed, comprehensive covered opinion. This approach favors taxpayers who can, and disadvantages taxpayers who cannot, afford to pay the substantial legal fees associated with such opinions. (Indeed, our Primary Recommendation would have this effect as well.) That approach runs contrary to the equitable approach to penalties inherent in existing tax law. Under Treasury Regulation Section 1.6664-4(c), "[a]ll facts and circumstances" are taken into account in determining whether a taxpayer has reasonably relied in good faith on advice, including the taxpayer's "education, sophistication and business experience." The December Regulations may have the effect of tilting things against the unsophisticated taxpayers that are meant to be protected by the December Regulations. By the same token, for taxpayers who could afford to pay for full-blown opinions but choose not to dedicate the resources (financial and time), the facts and circumstances approach of existing authority provides grounds for such a taxpayer not to enjoy penalty relief. Further, much of the tax shelter advice that the December Regulations are meant to regulate would not satisfy the minimum standards necessary for penalty protection under Treasury Regulation Section 1.6664-4(c) in any event, because it would not be based on "all pertinent facts and circumstances" or would make "unreasonable factual or legal assumptions." Thus, the December Regulations appear to be a means of rewriting and bolstering the requirements for penalty protection. We question whether the mechanism of regulating all written advice is the optimum means for achieving the goals that the December Regulations are meant to accomplish. Until a more efficient means is found to pursue those goals, however, we respectfully submit the above recommendations in order that the Service may apply workable practical standards for tax practice.