NYSBA

New York State Bar Association

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May 1, 2006

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Donald L. Korb
Chief Counsel
Internal Revenue Service
1111 Constitution Ave., NW
3026 IR
Washington, DC 20224

Mr. Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3112 MT
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: Circular 230

Dear Commissioner Everson, Messrs. Korb and Solomon:

The Tax Section of the New York State Bar Association is writing this letter in response to a request from Donald Korb, Chief Counsel of the IRS, to review and revise Circular 230 as it applies to written advice. Our members have now lived with the current version of Circular 230 for some time, and have to some extent digested its effect

on our day-to-day practices. This letter outlines our approach to revising Circular 230. For your reference, a proposed revision of Circular 230 and the correlative changes to Treas. Reg. § 1.6664-4(c) which embodies our suggested approach is attached hereto, together with a blackline against the current versions thereof.

Currently, under Circular 230, a practitioner giving written advice (including advice to his client) that falls under Circular 230's definition of a "covered opinion" may have an ethical obligation to disclose to the recipient of that advice that it does not protect the recipient from penalties, unless the practitioner complies with Section 10.35 of Circular 230. That section sets forth detailed standards which might be considered appropriate for a "tax shelter" opinion. However, the class of cases to which this ethical obligation may apply is extremely broad, or at least is perceived to be so by practitioners. The breadth of the current definitions of "covered opinion" and "written advice" make it impractical for practitioners to scrutinize every e-mail or other written communication they send to determine whether or not such writings are covered opinions (see *New York State Bar Association Tax Section, Report on Circular 230 Regulations* (March 3, 2005) (the "*NYSBA Report*") at 11-35). It is perceived to be very easy inadvertently to render a "covered opinion" and very difficult to comply with the ethical standards for doing so without a legend. As a result, the nearly universal practice among tax practitioners since the present version of Circular 230 was promulgated has been to legend all written communications (e-mails, faxes, memoranda, opinions, disclosure statements in non-SEC filed documents and so forth) with a legend something like the following:

> "IRS Circular 230 Disclosure: Any U.S. tax advice herein (or in any attachments hereto) was not intended or written to be used, and cannot be used, by any taxpayer to avoid U.S. tax penalties. Any such tax advice that is used or referred to by others to promote, market or recommend any entity, plan or arrangement should be construed as written in connection with that promotion, marketing or recommendation, and the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor."

We believe that the over-use of the legend has had the following undesirable effects (aside from the administrative burden it imposed on practitioners to re-wire e-mail systems and the like):

1. The presence of the legend may give a taxpayer the impression that he is not penalty protected when in fact he may be protected in cases not involving tax shelters where the taxpayer had substantial authority, cases involving tax shelters where the client had a bona fide reasonable belief that it was more likely than not that he would prevail, and so forth. (See *Opinions Under Circular 230: New Standards of Professionalism?,* Presentation by Robert Cassanos to New York State Bar Association Tax Section, September 2004.)

2. It is not clear that the legend is in fact true, because the regulations under Section 6664 of the Code have not been revised to incorporate the requirements of Circular 230 or to preclude reliance upon a non-compliant covered opinion. Thus, it is unclear whether the legend has any substantive meaning. The legend may put the advisor in the undesirable position of having to explain to clients that the legend the advisor included in his communication might in fact mean nothing, which does not generally increase respect for the law, or else refrain from advising his clients on the meaning of the legend.

3. Given the burdensome requirements for giving a Section 10.35-compliant "covered opinion" and the uncertainty surrounding when it is required, practitioners spend large amounts of time trying to determine whether or not they are in compliance with Circular 230 when it is not customary or typical to legend an opinion. Examples include reorganization opinions that are referred to (but not required to be included) in SEC registered documents, and so forth. Practitioners have attempted to bring clarity to these issues as well, but have yet to receive an official response (at least publicly). (See *Letters from Leslie Samuels and Diana Wollman to the Office of Professional Responsibility, reprinted in 108 Tax Notes 473, BNA Daily Tax Report, August 15, 2005, G-7.*)

4. There are situations where it is unclear whether a practitioner may give any written advice at all (for example, a principal purpose transaction where the practitioner could not reach a more likely than not conclusion on one of the significant federal tax issues), or may give written advice only by complying with the detailed rules of Section 10.35 in circumstances where the benefits of such compliance does not appear warranted by the cost thereof (for example, where the client is highly sophisticated and seeks advice on a question of law as applied to preliminary or hypothetical facts).

We believe that current practices involving the application of Circular 230 to covered opinions are widely perceived as unsatisfactory. In response to your request, we have attempted to craft a more targeted version of Circular 230. In doing so, we have attempted to follow the current form of Circular 230 and the regulations as far as possible. What follows is an explanation of the product of our efforts, together with some background on an alternative approach that we ultimately decided not to recommend.

Our basic recommendation is to retain the "opt out" structure of the current Circular 230, but only for marketed opinions that do not meet the requirements of Section 10.35. We would narrow the scope of the definition of a marketed opinion. All other written advice would be subject only to Section 10.37 of Circular 230, which would be modified to prohibit a practitioner from making unreasonable factual assumptions (including as to business purpose). Section 10.37 would accordingly be broadened slightly, but a "rule of reason" would be incorporated therein. Conforming changes would be made to the Section 6664 regulations, such that a taxpayer would not be permitted to rely on an opinion that contains the "opt out" legend.

If our proposals operate as we intend, the only types of opinions that cannot be relied upon within the meaning of the Section 6664 regulations would be marketed opinions that fail to satisfy the requirements of Section 10.35, which opinions will be required to contain an opt out and marketing legend. In cases not involving marketed opinions, practitioners would be subject to Section 10.37 (as modified) and present 10.51(l) (which is attached for your reference). The net result would be that the vast majority of written tax advice should not carry a legend, and marketed opinions (as defined) would be subject to the same rules they are currently subject to.

The current version of Circular 230 is aimed both at taxpayers – seeking to limit the types of written advice on which they may justifiably rely – and tax advisors – seeking to discourage the writing of unreasonable opinions. We believe that our proposal strikes a balance between these two roles, but we acknowledge that as long as Circular 230 is aimed at both of these problems, no solution will ever be perfect. The intended result is greater clarity for advisors and taxpayers and greater ease of administration for the government. More detailed comments on particular changes of the approach adopted are set forth below.

1. Limit the Opt Out Legend to Marketed Opinions. Currently, each item of written advice concerning (i) a listed transaction, (ii) a transaction that meets the principal purpose test, or (iii) a transaction that meets the significant purpose test and meets certain other criteria (e.g., reliance or marketed opinion) is a covered opinion. In certain circumstances a practitioner can opt out of delivering a covered opinion by attaching a legend to the written advice. The primary change to Circular 230 is to amend Section 10.35 so that written tax advice will constitute a "covered opinion" only if it concerns a significant purpose transaction that is a marketed opinion. A practitioner may still opt out of covered opinion status by inserting a marketed opinion legend. All other written advice would be subject to the rules for other written advice in Section 10.37. With the adoption of this approach, the exclusion for initial advice is no longer necessary and has been eliminated.

2. Conform the Regulations. A conforming change was made to Treas. Reg. §1.6664-4(c)(1) so that an opinion may not be relied upon if it incorporates an opt out legend.

3. Narrow the Definition of a Marketed Opinion. Currently, under Circular 230 Section 10.35(b)(5) written advice can be a "marketed opinion" if the practitioner knows or has reason to know that the advice will be used or referred to in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement. The terms "referred to" and "recommending" caused many unintended situations to fall under the definition of a marketed opinion (see NYSBA Report, at 17-23) and have therefore been removed from the definition of a marketed opinion. Additionally, the current definition provides that the advice will be a marketed opinion if it is marketed, even if there is no significant federal tax issue (an issue that the IRS

has a reasonable basis for a successful challenge and its resolution could have a significant impact.) The definition is changed so that a "marketed opinion" would be limited to opinions that conclude at a confidence level of more likely than not that a significant federal tax issue would be resolved in the taxpayer's favor. We feel that it is critical that the definition of a marketed opinion be narrow enough so that practitioners do not feel the need to legend every e-mail. In furtherance of this goal, if you were to adopt the approach set forth, we would recommend seeking further input to craft either a "safe harbor" or a favorable presumption for ordinary course and/or casual e-mails to avoid or minimize the possibility of a resurgence of routine legending if practitioners find it too difficult to determine whether or not such casual communications are "marketed."

4. Limit Section 10.35(c) to Significant Federal Tax Issues. Circular 230 Section 10.35(c) currently requires a practitioner writing a covered opinion to identify and ascertain the facts, determine which facts are relevant and relate the law to the facts. Additionally, the practitioner must not base the opinion on any unreasonable factual assumptions. As currently drafted, it is unclear whether these rules apply to all federal tax issues discussed in the opinion, or only to significant federal tax issues. (See NYSBA Report, at 36-37). The regulations are clarified to state that these rules only apply to significant federal tax issues.

5. Eliminate Certain Prohibitions. Circular 230 Section 10.35(c)(3)(iii) currently prohibits a practitioner writing a covered opinion to use internally inconsistent legal analyses or to take into account that an issue will be resolved through settlement. We believe that both of these prohibitions should be allowed in written advice that is a covered opinion. (See NYSBA Report, at 36-37). Accordingly, the prohibitions against having internally inconsistent legal analyses and taking into account that an issue will be resolved through settlement in a covered opinion have been removed. Similarly, Circular 230 Section 10.37(a) currently prohibits a practitioner giving "other written advice" (written advice that is not a covered opinion) from taking into account that an issue will be resolved through settlement. We also believe that the prohibition against taking into account that an issue will be resolved through settlement in a covered opinion is inappropriate, and it has been removed.

6. Eliminate Limited Scope Opinions. Circular 230 Section 10.35(c)(3)(v) currently permits a practitioner writing a covered opinion to evaluate fewer than all of the significant federal tax issues (a "Limited Scope Opinion") if the practitioner complies with certain disclosure requirements. Advice that is a marketed opinion, however, may not be a Limited Scope Opinion and the practitioner must evaluate all significant federal tax issues. We considered allowing marketed opinions to be Limited Scope Opinions, but decided that there was a risk that doing so would arguably permit a promoter to avoid putting a legend on a covered opinion that did not cover certain significant tax issues because a Limited Scope Opinion was being given on other such issues. Accordingly, because under our approach all covered opinions are marketed opinions, we removed the references to Limited Scope Opinions as no longer relevant.

7. Amend Section 10.37. Circular 230 Section 10.37 currently prohibits a practitioner making unreasonable factual or legal assumptions. Our draft broadens the prohibition to include assumptions, currently prohibited in covered opinions, about factual matters and representations. An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or incomplete. For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. In light of the fact that Section 10.37 applies to all written advice that is not a covered opinion, the prohibition against making unreasonable factual assumptions is subject to a rule of reason. For example, making factual assumptions in advising a long-time client may be reasonable, whereas it may not be reasonable to make the same factual assumptions in advising a new client. Additionally, because the prohibition against unreasonable assumptions was broadened to match the standard for covered opinions, the higher scrutiny given to marketed opinions is no longer appropriate and is deleted.

8. Clarify When an Opinion May Be Relied Upon. A clarifying change was made to Treas. Reg. §1.6664-4(b)(1) so that tax advice may be taken into account in determining whether a taxpayer acted with reasonable cause and good faith. Under the current regulations all pertinent facts and circumstances are to be taken into account when determining whether a taxpayer acted with reasonable cause and good faith. The regulations further provide, however, that reliance on tax advice does not necessarily demonstrate reasonable cause and good faith. As noted further below, with the exception of legended opinions, we believe that it would be unfair to taxpayers to apply an "exclusionary rule" under which any tax advice not complying with the standards of Circular 230 must be disregarded in determining reasonable cause and good faith. Accordingly, the regulation was changed to clarify that while receipt of tax advice does not necessarily demonstrate reasonable cause and good faith, it is nevertheless one of the pertinent facts taken into account when making such determination.

We recognize that the government may have an interest in preventing taxpayers from relying upon opinions that meet less than all of the standards currently set forth in Section 10.35. For this and other reasons, we carefully considered an alternative "opt in" approach. Such an approach would retain the "opt out" structure of current Circular 230, but only for a defined class of cases involving marketed opinions, where the definition of a marketed opinion is targeted to cases involving "promotion" in a manner consistent with the NYSBA Report (see NYSBA Report, at 17-19). For other cases currently covered by the "opt out" rules of the present Circular 230, an "opt in" rule would have been substituted instead, and conforming changes would have been made to the penalty regulations under Section 6664. We did not believe that a "pure" opt in approach, which would apply to all written communications, should be considered. Although such an approach might avoid the need for unnecessary legending, it would leave the recipients of marketed opinions without the protection of the warnings for marketed opinions, thus frustrating the "consumer protection" aspect of current Circular 230.

Even the two-tier opt in approach was ultimately rejected, for several reasons. First, we felt that having two levels of legending, an opt in legend for penalty protection and an opt-out legend for marketed opinions, would be confusing for practitioners. The concern expressed was that the current system was widely perceived as too complex, although it had only two options, whereas the alternative opt in approach had three. Second, the adoption of such an approach would create confusion in transitioning from the present system. In the present system, the absence of a Circular 230 legend has become de facto assurance that the recipient is penalty protected. Under an opt in approach, the absence of a legend would have meant the exact opposite. Absence of a legend would negate penalty protection in many – but not all – cases. While this confusion could ultimately have been overcome with a very substantial educational effort by the government and the bar, it was not apparent why such an effort should be undertaken when the recipient of the message would still be unable to understand the meaning of the absence of a legend (since its absence would have one meaning if the written advice was covered and another if it was not covered). A related concern was that practitioners would continue to resort to routine opt out legending to put their clients on notice of the absence of an opt in feature.

Finally, we believe that any approach that prohibits a taxpayer from relying on written advice should be narrowly drawn. In theory, the rules could make every non-legended communication (whether or not rising to the level of a covered opinion) irrelevant to the determination of penalty protection. In the same way, limiting reliance to opinions containing an opt in legend would result in a situation in which only sophisticated, well-advised taxpayers (and their advisors) would have access to the reasonable cause exception, a result which we feel is undesirable.

We appreciate your consideration of our comments and would be pleased to discuss them with you further. We would be happy, as well, to provide any other assistance that you would find helpful.

Respectfully submitted,

Kimberly S. Blanchard
Chair

Attachments

Cc: Michael Desmond, Tax Legislative Counsel
U.S. Treasury Department
Stephen Whitlock, Deputy Director,
IRS Office of Professional Responsibility

Standards based Approach

1. Reg § 10.22. [Circular 230] Diligence as to accuracy.

(a) In general. A practitioner must exercise due diligence—

(1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

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

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

(b) Reliance on others. Except as provided in §§10.33 and 10.34, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

2. Reg § 10.35. [Circular 230] Requirements for covered opinions.

(a) A practitioner who provides a covered opinion shall comply with the standards of practice in this section.

(b) Definitions. For purposes of this subpart—

(1) A *practitioner* includes any individual described in § 10.2(e).

(2) Covered opinion.

(i) In general. A *covered opinion* is written advice (including electronic communications) by a practitioner concerning one or more Federal tax issues arising from any 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 any tax imposed by the Internal Revenue Code if the advice concludes at a confidence level of more likely than not (a greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor, and the practitioner knows or has reason to know that the written advice will be used by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting or marketing a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).

(ii) For purposes of this section, written advice is not treated as a covered opinion if the practitioner prominently discloses in the written advice that—

(A) The advice was not intended or written by the practitioner to be used, and that it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer;

(B) The advice was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice; and

(C) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

(iii) Excluded advice. A covered opinion does not include—

(A) Written advice that—

(1) Concerns the qualification of a qualified plan;

(2) Is a State or local bond opinion; or

(3) Is included in documents required to be filed with the Securities and Exchange Commission;

(3) A *Federal tax issue* is a question concerning the Federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for Federal tax purposes. For purposes of this subpart, a Federal tax issue is significant if the Internal Revenue Service has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.

(4) Prominently disclosed. An item is *prominently disclosed* if it is readily apparent to a reader of the written advice. Whether an item is readily apparent will depend on the facts and circumstances surrounding the written advice including, but not limited to, the sophistication of the taxpayer and the length of the written advice. At a minimum, to be prominently disclosed an item must be set forth in a separate section (and not in a footnote) in a typeface that is the same size or larger than the typeface of any discussion of the facts or law in the written advice.

(5) State or local bond opinion. State or local bond opinion is written advice with respect to a Federal tax issue included in any materials delivered to a purchaser of a State or local bond in connection with the issuance of the bond in a public or private offering, including an official statement (if one is prepared), that concerns only the excludability of interest on a State or local bond from gross income under section 103 of the Internal Revenue Code, the application of section 55 of the Internal Revenue Code to a State or local bond, the status of a State or local bond as a qualified tax- exempt obligation under section 265(b)(3) of the Internal Revenue Code, the status of a State or local bond as a qualified zone academy bond under section 1397E of the Internal Revenue Code, or any combination of the above.

(c) Requirements for covered opinions. A practitioner providing a covered opinion must comply with each of the following requirements.

(1) Factual matters.

(i) The practitioner must use reasonable efforts to identify and ascertain the facts relevant to a significant Federal tax issue, which may relate to future events if a transaction is prospective or proposed, and to determine which facts are relevant. The opinion must identify and consider all facts that the practitioner determines to be relevant.

(ii) The practitioner must not base the opinion on any unreasonable factual assumptions relevant to a significant Federal tax issue (including assumptions as to future events). An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or incomplete. For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. A factual assumption includes reliance on a projection, financial forecast or appraisal. It is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the

practitioner knows or should know that the projection, financial forecast or appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such projection, financial forecast or appraisal. The opinion must identify in a separate section all factual assumptions relied upon by the practitioner.

(iii) The practitioner must not base the opinion on any unreasonable factual representations relevant to a significant Federal tax issue, statements or findings of the taxpayer or any other person. An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete. For example, a practitioner may not rely on a factual representation that a transaction has a business purpose if the representation does not include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete. The opinion must identify in a separate section all factual representations, statements or findings of the taxpayer relied upon by the practitioner.

(2) Relate law to facts.

(i) The opinion must relate the applicable law about a significant Federal tax issue (including potentially applicable judicial doctrines) to the relevant facts.

(ii) The practitioner must not assume the favorable resolution of any significant Federal tax issue except as provided in paragraph (d) of this section, or otherwise base an opinion on any unreasonable legal assumptions, representations, or conclusions.

(3) Evaluation of significant Federal tax issues.

(i) In general. The opinion must consider all significant Federal tax issues except as provided in paragraph (d) of this section.

(ii) Conclusion as to each significant Federal tax issue. The opinion must provide the practitioner's conclusion that the taxpayer will prevail on the merits at a confidence level of at least more likely than not with respect to each significant Federal tax issue. If the practitioner is unable to reach a more likely than not conclusion with respect to each significant Federal tax issue, the practitioner must not provide the marketed opinion, but may provide written advice that satisfies the requirements in paragraph (b)(2)(ii) of this section.

(iii) Evaluation based on chances of success on the merits. In evaluating the significant Federal tax issues addressed in the opinion, the practitioner must not take into account the possibility that a tax return will not be audited or that an issue will not be raised on audit.

(4) Overall conclusion.

(i) The opinion must provide the practitioner's overall conclusion as to the likelihood that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion. If the practitioner is unable to reach an overall conclusion, the opinion must state that the practitioner is unable to reach an overall conclusion and describe the reasons for the practitioner's inability to reach a conclusion.

(d) Competence to provide opinion; reliance on opinions of others.

(1) The practitioner must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered, except that the practitioner may rely on the opinion of another practitioner with respect to one or more significant Federal tax issues, unless the practitioner knows or should know that the opinion of the other practitioner should not be relied on. If a practitioner relies on the opinion of

another practitioner, the relying practitioner's opinion must identify the other opinion and set forth the conclusions reached in the other opinion.

(2) The practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion, if any, satisfy the requirements of this section.

(e) Required disclosures. A covered opinion must contain all of the following disclosures that apply—

(1) Relationship between promoter and practitioner. An opinion must prominently disclose the existence of—

(i) Any compensation arrangement, such as a referral fee or a fee- sharing arrangement, between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and any person (other than the client for whom the opinion is prepared) with respect to promoting or marketing the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion; or

(ii) Any referral agreement between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and a person (other than the client for whom the opinion is prepared) engaged in promoting or marketing the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion.

(2) Marketed. The opinion must prominently disclose that—

(i) The opinion was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in the opinion; and

(ii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

(3) Advice regarding required disclosures. In the case of any disclosure required under this section, the practitioner may not provide advice to any person that is contrary to or inconsistent with the required disclosure.

(f) Effect of opinion that meets these standards.

(1) In general. An opinion that meets the requirements of this section satisfies the practitioner's responsibilities under this section, but the persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion will be determined separately under applicable provisions of the law and regulations.

(2) Standards for other written advice. A practitioner who provides written advice that is not a covered opinion for purposes of this section is subject to the requirements of §10.37.

(g) Effective date. This section applies to written advice that is rendered after [ ].

3. Reg § 10.36. [Circular 230] Procedures to ensure compliance.

(a) Requirements for covered opinions. Any practitioner who has (or practitioners who have or share) principal authority and responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with §10.35. Any such practitioner will be subject to discipline for failing to comply with the requirements of this paragraph if—

(1) The practitioner through willfulness, recklessness, or gross incompetence does not take reasonable steps to ensure that the firm has adequate procedures to

comply with §10.35, and one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, of failing to comply with §10.35; or *(2)* The practitioner knows or should know that one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, that does not comply with §10.35 and the practitioner, through willfulness, recklessness, or gross incompetence, fails to take prompt action to correct the noncompliance.

(b) Effective date. This section is applicable after [ ].

4. Reg § 10.37. [Circular 230] Requirements for other written advice.

(a) Requirements. A practitioner must not give written advice (including electronic communications) concerning one or more Federal tax issues if the practitioner bases the written advice on unreasonable factual or legal assumptions (including assumptions as to future events), unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person, does not consider all relevant facts that the practitioner knows or should know, or, in evaluating a Federal tax issue, takes into account the possibility that a tax return will not be audited or that an issue will not be raised on audit. An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or incomplete. For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. A factual assumption includes reliance on a projection, financial forecast or appraisal. It is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the practitioner knows or should know that the projection, financial forecast or appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such projection, financial forecast or appraisal. An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete. For example, a practitioner may not rely on a factual representation that a transaction has a business purpose if the representation does not include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete. All facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client will be considered in determining how the standards set forth above are to be interpreted in each case as well as whether a practitioner has failed to comply with this section.

(b) Effective date. This section applies to written advice that is rendered after [ ].

5. Reg § 10.51. [Circular 230] Incompetence and disreputable conduct.

Incompetence and disreputable conduct for which a practitioner may be censured, suspended or disbarred from practice before the Internal Revenue Service includes, but is not limited to—

(a) Conviction of any criminal offense under the revenue laws of the United States;

(b) Conviction of any criminal offense involving dishonesty or breach of trust;

(c) Conviction of any felony under Federal or State law for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service;
(d) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing such information to be false or misleading. Facts or other matters contained in testimony, Federal tax returns, financial statements, applications for enrollment, affidavits, declarations, or any other document or statement, written or oral, are included in the term information.
(e) Solicitation of employment as prohibited under §10.30, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the Internal Revenue Service or officer or employee thereof.
(f) Willfully failing to make a Federal tax return in violation of the revenue laws of the United States, willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof.
(g) Misappropriation of, or failure properly and promptly to remit funds received from a client for the purpose of payment of taxes or other obligations due the United States.
(h) Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by the offer of any special inducement or promise of advantage or by the bestowing of any gift, favor or thing of value.
(i) Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any State, territory, possession of the United States, including a Commonwealth, or the District of Columbia, any Federal court of record or any Federal agency, body or board.
(j) Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.
(k) Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations and statements, knowing them to be false, or circulating or publishing malicious or libelous matter.
(l) Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions described in this paragraph (l) include those which reflect or result from a knowing misstatement of fact or law, from an assertion of a position known to be unwarranted under existing law, from counseling or assisting in conduct known to be illegal or fraudulent, from concealing matters required by law to be revealed, or from consciously disregarding information indicating that material facts expressed in the tax opinion or offering material are false or misleading. For purposes of this paragraph (l), reckless conduct is a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances. A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted knowingly, recklessly, or through gross incompetence. Gross incompetence includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.

6. Reg § 1.6664-4.

(a) In general. No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Rules for determining whether the reasonable cause and good faith exception applies are set forth in paragraphs (b) through (h) of this section.

(b) Facts and circumstances taken into account.

(1) In general. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. (See paragraph (e) of this section for certain rules relating to a substantial understatement penalty attributable to tax shelter items of corporations.) Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith, but may be taken into account in making such determination. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. (See paragraph (c) of this section for certain rules relating to reliance on the advice of others.) For example, reliance on erroneous information (such as an error relating to the cost or adjusted basis of property, the date property was placed in service, or the amount of opening or closing inventory) inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions generally indicates reasonable cause and good faith, provided the corporation employed internal controls and procedures, reasonable under the circumstances, that were designed to identify such factual errors. Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used. (See paragraph (g) of this section for special rules relating to appraisals for charitable deduction property.) A taxpayer's reliance on erroneous information reported on a Form W-2, Form 1099 or other information return indicates reasonable cause and good faith, provided the taxpayer did not know or have reason to know that the information was incorrect. Generally, a taxpayer knows, or has reason to know, that the information on an information return is incorrect if such information is inconsistent with other information reported or otherwise furnished to the taxpayer, or with the taxpayer's knowledge of the transaction. This knowledge includes, for example, the taxpayer's knowledge of the terms of his employment relationship or of the rate of return on a payor's obligation.

(2) Examples. The following examples illustrate this paragraph (b). They do not involve tax shelter items. (See paragraph (e) of this section for certain rules relating to the substantial understatement penalty attributable to the tax shelter items of corporations.)

Example (1). A, an individual calendar year taxpayer, engages B, a professional tax advisor, to give A advice concerning the deductibility of certain state and local taxes. A provides B with full details concerning the taxes at issue. B advises A that the taxes are fully deductible. A, in preparing his own tax return, claims a deduction for the taxes. Absent other facts, and assuming the facts and circumstances surrounding B's advice and A's reliance on such advice satisfy the requirements of paragraph (c) of this section, A is considered to have demonstrated good faith by seeking the advice of a professional tax advisor, and to have shown reasonable cause for any underpayment attributable to the deduction claimed for the taxes. However, if A had sought advice from someone that he knew, or should have known, lacked knowledge in the relevant aspects of Federal tax law, or if other facts demonstrate that A failed to act reasonably or in good faith, A would not be considered to have shown reasonable cause or to have acted in good faith.

Example (2). C, an individual, sought advice from D, a friend who was not a tax professional, as to how C might reduce his Federal tax obligations. D advised C that, for a nominal investment in Corporation X, D had received certain tax benefits which virtually eliminated D's Federal tax liability. D also named other investors who had received similar benefits. Without further inquiry, C invested in X and claimed the benefits that he had been assured by D were due him. In this case, C did not make any good faith attempt to ascertain the correctness of what D had advised him concerning his tax matters, and is not considered to have reasonable cause for the underpayment attributable to the benefits claimed.

Example (3). E, an individual, worked for Company X doing odd jobs and filling in for other employees when necessary. E worked irregular hours and was paid by the hour. The amount of E's pay check differed from week to week. The Form W-2 furnished to E reflected wages for 1990 in the amount of $29,729. It did not, however, include compensation of $1,467 paid for some hours E worked. Relying on the Form W-2, E filed a return reporting wages of $29,729. E had no reason to know that the amount reported on the Form W-2 was incorrect. Under the circumstances, E is considered to have acted in good faith in relying on the Form W-2 and to have reasonable cause for the underpayment attributable to the unreported wages.

Example (4). H, an individual, did not enjoy preparing his tax returns and procrastinated in doing so until April 15th. On April 15th, H hurriedly gathered together his tax records and materials, prepared a return, and mailed it before midnight. The return contained numerous errors, some of which were in H's favor and some of which were not. The net result of all the adjustments, however, was an underpayment of tax by H. Under these circumstances, H is not considered to have reasonable cause for the underpayment or to have acted in good faith in attempting to file an accurate return.

(c) Reliance on opinion or advice.

(1) Facts and circumstances; minimum requirements. All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith. In no event will a taxpayer be considered to have reasonably relied in good

faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) All facts and circumstances considered. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

(ii) No unreasonable assumptions. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.

(iii) Reliance on the invalidity of a regulation. A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with §1.6662-3(c)(2), the position that the regulation in question is invalid.

(iv) Non Reliance Language. A taxpayer may not rely on an opinion or advice that contains the legend referred to in Circular 230 10.35(b)(2)(ii).

(2) Advice defined. Advice is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.

(3) Cross-reference. For rules applicable to advisors, see e.g., §§1.6694-1 through 1.6694-3 (regarding preparer penalties), 31 CFR 10.22 (regarding diligence as to accuracy), 31 CFR 10.33 (regarding tax shelter opinions), and 31 CFR 10.34 (regarding standards for advising with respect to tax return positions and for preparing or signing returns).

(d) Underpayments attributable to reportable transactions. If any portion of an underpayment is attributable to a reportable transaction, as defined in §1.6011-4(b) (or

§1.6011-4T(b), as applicable), then failure by the taxpayer to disclose the transaction in accordance with §1.6011-4 (or §1.6011-4T, as applicable) is a strong indication that the taxpayer did not act in good faith with respect to the portion of the underpayment attributable to the reportable transaction.

(e) Pass-through items. The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity.

(f) Special rules for substantial understatement penalty attributable to tax shelter items of corporations.

(1) In general; facts and circumstances. The determination of whether a corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item (as defined in §1.6662-4(g)(3)) is based on all pertinent facts and circumstances. Paragraphs (f)(2), (3), and (4) of this section set forth rules that apply, in the case of a penalty attributable to a substantial understatement of income tax (within the meaning of section 6662(d)), in determining whether a corporation acted with reasonable cause and in good faith with respect to a tax shelter item.

(2) Reasonable cause based on legal justification.

(i) Minimum requirements. A corporation's legal justification (as defined in paragraph (e)(2)(ii) of this section) may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item only if the authority requirement of paragraph (f)(2)(i)(A) of this section and the belief requirement of paragraph (f)(2)(i)(B) of this section are satisfied (the minimum requirements). Thus, a failure to satisfy the minimum requirements will preclude a finding of reasonable cause and good faith based (in whole or in part) on the corporation's legal justification.

(A) Authority requirement. The authority requirement is satisfied only if there is substantial authority (within the meaning of §1.6662-4(d)) for the tax treatment of the item.

(B) Belief requirement. The belief requirement is satisfied only if, based on all facts and circumstances, the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper treatment. For purposes of the preceding sentence, a corporation is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled)—

(1) The corporation analyzes the pertinent facts and authorities in the manner described in §1.6662-4(d)(3)(ii), and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood

that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(2) The corporation reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in §1.6662-4(d)(3)(ii) and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service. (For this purpose, the requirements of paragraph (c) of this section must be met with respect to the opinion of a professional tax advisor.)

(ii) Legal justification defined. For purposes of this paragraph (f), legal justification includes any justification relating to the treatment or characterization under the Federal tax law of the tax shelter item or of the entity, plan, or arrangement that gave rise to the item. Thus, a taxpayer's belief (whether independently formed or based on the advice of others) as to the merits of the taxpayer's underlying position is a legal justification.

(3) Minimum requirements not dispositive. Satisfaction of the minimum requirements of paragraph (f)(2) of this section is an important factor to be considered in determining whether a corporate taxpayer acted with reasonable cause and in good faith, but is not necessarily dispositive. For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.

(4) Other factors. Facts and circumstances other than a corporation's legal justification may be taken into account, as appropriate, in determining whether the corporation acted with reasonable cause and in good faith with respect to a tax shelter item regardless of whether the minimum requirements of paragraph (f)(2) of this section are satisfied.

(g) Transactions between persons described in section 482 and net section 482 transfer price adjustments. [Reserved]

(h) Valuation misstatements of charitable deduction property.

(1) In general. There may be reasonable cause and good faith with respect to a portion of an underpayment that is attributable to a substantial (or gross) valuation misstatement of charitable deduction property (as defined in paragraph (h)(2) of this section) only if—

(i) The claimed value of the property was based on a qualified appraisal (as defined in paragraph (h)(2) of this section) by a qualified appraiser (as defined in paragraph (h)(2) of this section); and

(ii) In addition to obtaining a qualified appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

(2) Definitions. For purposes of this paragraph (h): *Charitable deduction property* means any property (other than money or publicly traded securities, as defined in §1.170A-13(c)(7)(xi)) contributed by the taxpayer in a contribution for which a deduction was claimed under section 170. *Qualified appraisal* means a qualified appraisal as defined in §1.170A-13(c)(3). *Qualified appraiser* means a qualified appraiser as defined in §1.170A-13(c)(5).

(3) Special rules. The rules of this paragraph (h) apply regardless of whether §1.170A-13 permits a taxpayer to claim a charitable contribution deduction for the property without obtaining a qualified appraisal. The rules of this paragraph (h) apply in addition to the generally applicable rules concerning reasonable cause and good faith.

Standards based Approach

1. Reg § 10.22. [Circular 230] Diligence as to accuracy.

(a) In general. A practitioner must exercise due diligence—

(1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

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

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

(b) Reliance on others. Except as provided in §§10.33 and 10.34, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

2. Reg § 10.35. [Circular 230] Requirements for covered opinions.

(a) A practitioner who provides a covered opinion shall comply with the standards of practice in this section.

(b) Definitions. For purposes of this subpart—

(1) A *practitioner* includes any individual described in § 10.2(e).

(2) Covered opinion.

(i) In general. A *covered opinion* is written advice (including electronic communications) by a practitioner concerning one or more Federal tax issues arising from—

~~(A) A transaction that is the same as or substantially similar to a transaction that, at the time the advice is rendered, the Internal Revenue Service has determined to be a tax avoidance transaction and identified by published guidance as a listed transaction under 26 CFR 1.6011-4(b)(2);~~

~~(B) Any 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 any tax imposed by the Internal Revenue Code; or (C) Any~~ any 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 any tax imposed by the Internal Revenue Code if the ~~written advice—~~advice concludes at a confidence level of more likely than not (a greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor, and the practitioner knows or has reason to know that the written advice will be used by a person other than the practitioner (or a person who is a member of, associated with, or

employed by the practitioner's firm) in promoting or marketing a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).

~~(1) Is a reliance opinion;~~

~~(2) Is a marketed opinion;~~

~~(3) Is subject to conditions of confidentiality; or~~

~~(4) Is subject to contractual protection.~~

(ii) For purposes of this section, written advice is not treated as a covered opinion if the practitioner prominently discloses in the written advice that—

(A) The advice was not intended or written by the practitioner to be used, and that it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer;

(B) The advice was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice; and

(C) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

(iii) Excluded advice. A covered opinion does not include—

(A) Written advice ~~provided to a client during the course of an engagement if a practitioner is reasonably expected to provide subsequent written advice to the client that satisfies the requirements of this section; (B) Written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(ii)(B) [sic (i)] of this section (concerning the principal purpose of avoidance or evasion)~~ that—

(1) Concerns the qualification of a qualified plan;

(2) Is a State or local bond opinion; or

(3) Is included in documents required to be filed with the Securities and Exchange Commission;

~~(C) Written advice prepared for and provided to a taxpayer, solely for use by that taxpayer, after the taxpayer has filed a tax return with the Internal Revenue Service reflecting the tax benefits of the transaction. The preceding sentence does not apply if the practitioner knows or has reason to know that the written advice will be relied upon by the taxpayer to take a position on a tax return (including for these purposes an amended return that claims tax benefits not reported on a previously filed return) filed after the date on which the advice is provided to the taxpayer;~~

~~(D) Written advice provided to an employer by a practitioner in that practitioner's capacity as an employee of that employer solely for purposes of determining the tax liability of the employer; or~~

~~(E) Written advice that does not resolve a Federal tax issue in the taxpayer's favor, unless the advice reaches a conclusion favorable to the taxpayer at any confidence level (e.g., not frivolous, realistic possibility of success, reasonable basis or substantial authority) with respect to that issue. If written advice concerns more than one Federal tax issue, the advice must comply with the requirements of paragraph (c) of this section with respect to any Federal tax issue not described in the preceding sentence.~~

(3) A *Federal tax issue* is a question concerning the Federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for Federal tax purposes. For purposes of this subpart, a Federal tax issue is significant if the Internal Revenue Service has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.

(4) Reliance opinion.

(i) Written advice is a *reliance opinion* if the advice concludes at a confidence level of at least more likely than not (a greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor.

(ii) For purposes of this section, written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion), is not treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

(5) Marketed opinion.

(i) Written advice is a *marketed opinion* if the practitioner knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).

(ii) For purposes of this section, written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion), is not treated as a marketed opinion if the practitioner prominently discloses in the written advice that—

(A) The advice was not intended or written by the practitioner to be used, and that it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer;

(B) The advice was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice; and

(C) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

(6) Conditions of confidentiality. Written advice is subject to conditions of confidentiality if the practitioner imposes on one or more recipients of the written advice a limitation on disclosure of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that practitioner's tax strategies, regardless of whether the limitation on disclosure is legally binding. A claim that a transaction is proprietary or exclusive is not a limitation on disclosure if the practitioner confirms to all recipients of the written advice that there is no limitation on disclosure of the tax treatment or tax structure of the transaction that is the subject of the written advice.

~~*(7) Contractual protection.* Written advice is subject to contractual protection if the taxpayer has the right to a full or partial refund of fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) if all or a part of the intended tax consequences from the matters addressed in the written advice are not sustained, or if the fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) are contingent on the taxpayer's realization of tax benefits from the transaction. All the facts and circumstances relating to the matters addressed in the written advice will be considered when determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties to a transaction have not designated as fees or any agreement to provide services without reasonable compensation.~~ *~~(8)~~ Prominently disclosed.* An item is *prominently disclosed* if it is readily apparent to a reader of the written advice. Whether an item is readily apparent will depend on the facts and circumstances surrounding the written advice including, but not limited to, the sophistication of the taxpayer and the length of the written advice. At a minimum, to be prominently disclosed an item must be set forth in a separate section (and not in a footnote) in a typeface that is the same size or larger than the typeface of any discussion of the facts or law in the written advice.

(~~9~~5) State or local bond opinion. State or local bond opinion is written advice with respect to a Federal tax issue included in any materials delivered to a purchaser of a State or local bond in connection with the issuance of the bond in a public or private offering, including an official statement (if one is prepared), that concerns only the excludability of interest on a State or local bond from gross income under section 103 of the Internal Revenue Code, the application of section 55 of the Internal Revenue Code to a State or local bond, the status of a State or local bond as a qualified tax- exempt obligation under section 265(b)(3) of the Internal Revenue Code, the status of a State or local bond as a qualified zone academy bond under section 1397E of the Internal Revenue Code, or any combination of the above.

~~*(10) The principal purpose.* For purposes of this section, the principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is the avoidance or evasion of any tax imposed by the Internal Revenue Code if that purpose exceeds any other purpose. The principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is not to avoid or evade Federal tax if that partnership, entity, plan or arrangement has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose. A partnership, entity, plan or arrangement may have a significant purpose of avoidance or evasion even though it does not have the principal purpose of avoidance or evasion under this paragraph (b)(10).~~

(c) Requirements for covered opinions. A practitioner providing a covered opinion must comply with each of the following requirements.

(1) Factual matters.

(i) The practitioner must use reasonable efforts to identify and ascertain the facts relevant to a significant Federal tax issue, which may relate to future events if a transaction is prospective or proposed, and to determine which facts are relevant. The opinion must identify and consider all facts that the practitioner determines to be relevant.

(ii) The practitioner must not base the opinion on any unreasonable factual assumptions relevant to a significant Federal tax issue (including assumptions as to future events). An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know

is incorrect or incomplete. For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. A factual assumption includes reliance on a projection, financial forecast or appraisal. It is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the practitioner knows or should know that the projection, financial forecast or appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such projection, financial forecast or appraisal. The opinion must identify in a separate section all factual assumptions relied upon by the practitioner.

(iii) The practitioner must not base the opinion on any unreasonable factual representations relevant to a significant Federal tax issue, statements or findings of the taxpayer or any other person. An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete. For example, a practitioner may not rely on a factual representation that a transaction has a business purpose if the representation does not include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete. The opinion must identify in a separate section all factual representations, statements or findings of the taxpayer relied upon by the practitioner.

(2) Relate law to facts.

(i) The opinion must relate the applicable law about a significant Federal tax issue (including potentially applicable judicial doctrines) to the relevant facts.

(ii) The practitioner must not assume the favorable resolution of any significant Federal tax issue except as provided in ~~paragraphs (c)(3)(v) and~~paragraph (d) of this section, or otherwise base an opinion on any unreasonable legal assumptions, representations, ~~or conclusions. (iii) The opinion must not contain internally inconsistent legal analyses~~ or conclusions.

(3) Evaluation of significant Federal tax issues.

(i) In general. The opinion must consider all significant Federal tax issues except as provided in ~~paragraphs (c)(3)(v) and~~paragraph (d) of this section.

(ii) Conclusion as to each significant Federal tax issue. The opinion must provide the practitioner's conclusion ~~as to the likelihood~~ that the taxpayer will prevail on the merits ~~with respect to~~ at a confidence level of at least more likely than not with respect to each significant Federal tax issue ~~considered in the opinion~~. If the practitioner is unable to reach a ~~conclusion with respect to one or more of those issues, the opinion must state that the practitioner is unable to reach a conclusion with respect to those issues. The opinion must describe the reasons for the conclusions, including the facts and analysis supporting the conclusions, or describe the reasons that the practitioner is unable to reach a conclusion as to one or more issues. If the practitioner fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues considered, the opinion must include the appropriate disclosure(s) required under paragraph (c~~more likely than not conclusion with respect to each significant Federal tax issue, the practitioner must not provide the marketed opinion, but may provide written advice that satisfies the requirements in paragraph (b)(2)(ii) of this section.

(iii) Evaluation based on chances of success on the merits. In evaluating the significant Federal tax issues addressed in the opinion, the practitioner must not take into account the possibility that a tax return will not be audited~~,~~ or that an issue will not be raised on audit~~, or that an issue will be resolved through settlement if raised.~~ .

~~(iv) Marketed opinions. In the case of a marketed opinion, the opinion must provide the practitioner's conclusion that the taxpayer will prevail on the merits at a confidence level of at least more likely than not with respect to each significant Federal tax issue. If the practitioner is unable to reach a more likely than not conclusion with respect to each significant Federal tax issue, the practitioner must not provide the marketed opinion, but may provide written advice that satisfies the requirements in paragraph (b)(5)(ii) of this section.~~

~~(v) Limited scope opinions.~~

~~(A) The practitioner may provide an opinion that considers less than all of the significant Federal tax issues if —~~

~~(1) The practitioner and the taxpayer agree that the scope of the opinion and the taxpayer's potential reliance on the opinion for purposes of avoiding penalties that may be imposed on the taxpayer are limited to the Federal tax issue(s) addressed in the opinion;~~

~~(2) The opinion is not advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions), paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion) or paragraph (b)(5) of this section (a marketed opinion); and~~

~~(3) The opinion includes the appropriate disclosure(s) required under paragraph (e) of this section.~~

~~(B) A practitioner may make reasonable assumptions regarding the favorable resolution of a Federal tax issue (an assumed issue) for purposes of providing an opinion on less than all of the significant Federal tax issues as provided in this paragraph (c)(3)(v). The opinion must identify in a separate section all issues for which the practitioner assumed a favorable resolution.~~

(4) Overall conclusion.

(i) The opinion must provide the practitioner's overall conclusion as to the likelihood that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion. If the practitioner is unable to reach an overall conclusion, the opinion must state that the practitioner is unable to reach an overall conclusion and describe the reasons for the practitioner's inability to reach a conclusion.

~~(ii) In the case of a marketed opinion, the opinion must provide the practitioner's overall conclusion that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment at a confidence level of at least more likely than not.~~

(d) Competence to provide opinion; reliance on opinions of others.

(1) The practitioner must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered, except that the practitioner may rely on the opinion of another practitioner with respect to one or more significant Federal tax issues, unless the practitioner knows or should know that the opinion of the other practitioner should not be relied on. If a practitioner relies on the opinion of

another practitioner, the relying practitioner's opinion must identify the other opinion and set forth the conclusions reached in the other opinion.

(2) The practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion, if any, satisfy the requirements of this section.

(e) Required disclosures. A covered opinion must contain all of the following disclosures that apply—

(1) Relationship between promoter and practitioner. An opinion must prominently disclose the existence of—

(i) Any compensation arrangement, such as a referral fee or a fee- sharing arrangement, between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and any person (other than the client for whom the opinion is prepared) with respect to promoting~~,~~ or marketing~~ or recommending~~ the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion; or

(ii) Any referral agreement between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and a person (other than the client for whom the opinion is prepared) engaged in promoting~~,~~ or marketing~~ or recommending~~ the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion.

(2) Marketed ~~opinions.~~ ~~A marketed~~*, The* opinion must prominently disclose that—

(i) The opinion was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in the opinion; and

(ii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

~~*(3) Limited scope opinions.* A limited scope opinion must prominently disclose that—~~

~~(i) The opinion is limited to the one or more Federal tax issues addressed in the opinion;~~

~~(ii) Additional issues may exist that could affect the Federal tax treatment of the transaction or matter that is the subject of the opinion and the opinion does not consider or provide a conclusion with respect to any additional issues; and~~

~~(iii) With respect to any significant Federal tax issues outside the limited scope of the opinion, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.~~

~~*(4) Opinions that fail to reach a more likely than not conclusion.* An opinion that does not reach a conclusion at a confidence level of at least more likely than not with respect to a significant Federal tax issue must prominently disclose that—~~

~~(i) The opinion does not reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues addressed by the opinion; and~~

~~(ii) With respect to those significant Federal tax issues, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.~~ ~~*(5)*~~ *Advice regarding required disclosures.* In the case of any disclosure required under this section, the practitioner may not provide advice to any person that is contrary to or inconsistent with the required disclosure.

(f) Effect of opinion that meets these standards.

(1) In general. An opinion that meets the requirements of this section satisfies the practitioner's responsibilities under this section, but the persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion will be determined separately under applicable provisions of the law and regulations.

(2) Standards for other written advice. A practitioner who provides written advice that is not a covered opinion for purposes of this section is subject to the requirements of §10.37.

(g) Effective date. This section applies to written advice that is rendered after ~~June 20, 2005.~~[ ].

3. Reg § 10.36. [Circular 230] Procedures to ensure compliance.

(a) Requirements for covered opinions. Any practitioner who has (or practitioners who have or share) principal authority and responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with §10.35. Any such practitioner will be subject to discipline for failing to comply with the requirements of this paragraph if—

(1) The practitioner through willfulness, recklessness, or gross incompetence does not take reasonable steps to ensure that the firm has adequate procedures to comply with §10.35, and one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, of failing to comply with §10.35; or

(2) The practitioner knows or should know that one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, that does not comply with §10.35 and the practitioner, through willfulness, recklessness, or gross incompetence, fails to take prompt action to correct the noncompliance.

(b) Effective date. This section is applicable after ~~June 20, 2005.~~[ ].

4. Reg § 10.37. [Circular 230] Requirements for other written advice.

(a) Requirements. A practitioner must not give written advice (including electronic communications) concerning one or more Federal tax issues if the practitioner bases the written advice on unreasonable factual or legal assumptions (including assumptions as to future events), unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person, does not consider all relevant facts that the practitioner knows or should know, or, in evaluating a Federal tax issue, takes into account the possibility that a tax return will not be audited~~,~~ or that an issue will not be raised on audit~~, or that an issue will be resolved through settlement if raised~~. An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or incomplete. For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. A factual assumption includes reliance on a projection, financial forecast or appraisal. It is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the practitioner knows or should know that the projection, financial forecast or appraisal is incorrect or incomplete or was prepared by a

person lacking the skills or qualifications necessary to prepare such projection, financial forecast or appraisal. An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete. For example, a practitioner may not rely on a factual representation that a transaction has a business purpose if the representation does not include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete. All facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client will be considered in determining ~~whether a practitioner has failed to comply with this section. In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, the determination of~~how the standards set forth above are to be interpreted in each case as well as whether a practitioner has failed to comply with this section ~~will be made on the basis of a heightened standard of care because of the greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances~~.

(b) Effective date. This section applies to written advice that is rendered after ~~June 20, 2004 [sic June 20, 2005~~[_____].

5. Reg § 10.51. [Circular 230] Incompetence and disreputable conduct.

Incompetence and disreputable conduct for which a practitioner may be censured, suspended or disbarred from practice before the Internal Revenue Service includes, but is not limited to—

(a) Conviction of any criminal offense under the revenue laws of the United States;

(b) Conviction of any criminal offense involving dishonesty or breach of trust;

(c) Conviction of any felony under Federal or State law for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service;

(d) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing such information to be false or misleading. Facts or other matters contained in testimony, Federal tax returns, financial statements, applications for enrollment, affidavits, declarations, or any other document or statement, written or oral, are included in the term information.

(e) Solicitation of employment as prohibited under §10.30, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the Internal Revenue Service or officer or employee thereof.

(f) Willfully failing to make a Federal tax return in violation of the revenue laws of the United States, willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof.

(g) Misappropriation of, or failure properly and promptly to remit funds received from a client for the purpose of payment of taxes or other obligations due the United States.
(h) Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by the offer of any special inducement or promise of advantage or by the bestowing of any gift, favor or thing of value.
(i) Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any State, territory, possession of the United States, including a Commonwealth, or the District of Columbia, any Federal court of record or any Federal agency, body or board.
(j) Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.
(k) Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations and statements, knowing them to be false, or circulating or publishing malicious or libelous matter.
(l) Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions described in this paragraph (l) include those which reflect or result from a knowing misstatement of fact or law, from an assertion of a position known to be unwarranted under existing law, from counseling or assisting in conduct known to be illegal or fraudulent, from concealing matters required by law to be revealed, or from consciously disregarding information indicating that material facts expressed in the tax opinion or offering material are false or misleading. For purposes of this paragraph (l), reckless conduct is a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances. A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted knowingly, recklessly, or through gross incompetence. Gross incompetence includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.

6. Reg § 1.6664-4.

(a) In general. No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Rules for determining whether the reasonable cause and good faith exception applies are set forth in paragraphs (b) through (h) of this section.
(b) Facts and circumstances taken into account.
(1) In general. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. (See paragraph (e) of this section for certain rules relating to a substantial understatement penalty attributable to tax shelter items of corporations.) Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the

taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith~~.~~, but may be taken into account in making such determination. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. (See paragraph (c) of this section for certain rules relating to reliance on the advice of others.) For example, reliance on erroneous information (such as an error relating to the cost or adjusted basis of property, the date property was placed in service, or the amount of opening or closing inventory) inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions generally indicates reasonable cause and good faith, provided the corporation employed internal controls and procedures, reasonable under the circumstances, that were designed to identify such factual errors. Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used. (See paragraph (g) of this section for special rules relating to appraisals for charitable deduction property.) A taxpayer's reliance on erroneous information reported on a Form W-2, Form 1099 or other information return indicates reasonable cause and good faith, provided the taxpayer did not know or have reason to know that the information was incorrect. Generally, a taxpayer knows, or has reason to know, that the information on an information return is incorrect if such information is inconsistent with other information reported or otherwise furnished to the taxpayer, or with the taxpayer's knowledge of the transaction. This knowledge includes, for example, the taxpayer's knowledge of the terms of his employment relationship or of the rate of return on a payor's obligation.

(2) Examples. The following examples illustrate this paragraph (b). They do not involve tax shelter items. (See paragraph (e) of this section for certain rules relating to the substantial understatement penalty attributable to the tax shelter items of corporations.)

Example (1). A, an individual calendar year taxpayer, engages B, a professional tax advisor, to give A advice concerning the deductibility of certain state and local taxes. A provides B with full details concerning the taxes at issue. B advises A that the taxes are fully deductible. A, in preparing his own tax return, claims a deduction for the taxes. Absent other facts, and assuming the facts and circumstances surrounding B's advice and A's reliance on such advice satisfy the requirements of paragraph (c) of this section, A is considered to have demonstrated good faith by seeking the advice of a professional tax advisor, and to have shown reasonable cause for any underpayment attributable to the deduction claimed for the taxes. However, if A had sought advice from someone that he knew, or should have known, lacked knowledge in the relevant aspects of Federal tax law, or if other facts demonstrate that A failed to act reasonably or in good faith, A would not be considered to have shown reasonable cause or to have acted in good faith.

Example (2). C, an individual, sought advice from D, a friend who was not a tax professional, as to how C might reduce his Federal tax obligations. D advised C that, for a nominal investment in Corporation X, D had received certain tax benefits which virtually eliminated D's Federal tax liability. D also named other investors who had received

similar benefits. Without further inquiry, C invested in X and claimed the benefits that he had been assured by D were due him. In this case, C did not make any good faith attempt to ascertain the correctness of what D had advised him concerning his tax matters, and is not considered to have reasonable cause for the underpayment attributable to the benefits claimed.

Example (3). E, an individual, worked for Company X doing odd jobs and filling in for other employees when necessary. E worked irregular hours and was paid by the hour. The amount of E's pay check differed from week to week. The Form W-2 furnished to E reflected wages for 1990 in the amount of $29,729. It did not, however, include compensation of $1,467 paid for some hours E worked. Relying on the Form W-2, E filed a return reporting wages of $29,729. E had no reason to know that the amount reported on the Form W-2 was incorrect. Under the circumstances, E is considered to have acted in good faith in relying on the Form W-2 and to have reasonable cause for the underpayment attributable to the unreported wages.

Example (4). H, an individual, did not enjoy preparing his tax returns and procrastinated in doing so until April 15th. On April 15th, H hurriedly gathered together his tax records and materials, prepared a return, and mailed it before midnight. The return contained numerous errors, some of which were in H's favor and some of which were not. The net result of all the adjustments, however, was an underpayment of tax by H. Under these circumstances, H is not considered to have reasonable cause for the underpayment or to have acted in good faith in attempting to file an accurate return.

(c) Reliance on opinion or advice.

(1) Facts and circumstances; minimum requirements. All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith. In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) All facts and circumstances considered. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

(ii) No unreasonable assumptions. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.

(iii) Reliance on the invalidity of a regulation. A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with §1.6662-3(c)(2), the position that the regulation in question is invalid.

(iv) Non Reliance Language. A taxpayer may not rely on an opinion or advice that contains the legend referred to in Circular 230 10.35(b)(2)(ii).

(2) Advice defined. Advice is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.

(3) Cross-reference. For rules applicable to advisors, see e.g., §§1.6694-1 through 1.6694-3 (regarding preparer penalties), 31 CFR 10.22 (regarding diligence as to accuracy), 31 CFR 10.33 (regarding tax shelter opinions), and 31 CFR 10.34 (regarding standards for advising with respect to tax return positions and for preparing or signing returns).

(d) Underpayments attributable to reportable transactions. If any portion of an underpayment is attributable to a reportable transaction, as defined in §1.6011-4(b) (or §1.6011-4T(b), as applicable), then failure by the taxpayer to disclose the transaction in accordance with §1.6011-4 (or §1.6011-4T, as applicable) is a strong indication that the taxpayer did not act in good faith with respect to the portion of the underpayment attributable to the reportable transaction.

(e) Pass-through items. The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity.

(f) Special rules for substantial understatement penalty attributable to tax shelter items of corporations.

(1) In general; facts and circumstances. The determination of whether a corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item (as defined in §1.6662-4(g)(3)) is based on all pertinent facts and

circumstances. Paragraphs (f)(2), (3), and (4) of this section set forth rules that apply, in the case of a penalty attributable to a substantial understatement of income tax (within the meaning of section 6662(d)), in determining whether a corporation acted with reasonable cause and in good faith with respect to a tax shelter item.

(2) Reasonable cause based on legal justification.

(i) Minimum requirements. A corporation's legal justification (as defined in paragraph (e)(2)(ii) of this section) may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item only if the authority requirement of paragraph (f)(2)(i)(A) of this section and the belief requirement of paragraph (f)(2)(i)(B) of this section are satisfied (the minimum requirements). Thus, a failure to satisfy the minimum requirements will preclude a finding of reasonable cause and good faith based (in whole or in part) on the corporation's legal justification.

(A) Authority requirement. The authority requirement is satisfied only if there is substantial authority (within the meaning of §1.6662-4(d)) for the tax treatment of the item.

(B) Belief requirement. The belief requirement is satisfied only if, based on all facts and circumstances, the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper treatment. For purposes of the preceding sentence, a corporation is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled)—

(1) The corporation analyzes the pertinent facts and authorities in the manner described in §1.6662-4(d)(3)(ii), and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(2) The corporation reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in §1.6662-4(d)(3)(ii) and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service. (For this purpose, the requirements of paragraph (c) of this section must be met with respect to the opinion of a professional tax advisor.)

(ii) Legal justification defined. For purposes of this paragraph (f), legal justification includes any justification relating to the treatment or characterization under the Federal tax law of the tax shelter item or of the

entity, plan, or arrangement that gave rise to the item. Thus, a taxpayer's belief (whether independently formed or based on the advice of others) as to the merits of the taxpayer's underlying position is a legal justification.

(3) Minimum requirements not dispositive. Satisfaction of the minimum requirements of paragraph (f)(2) of this section is an important factor to be considered in determining whether a corporate taxpayer acted with reasonable cause and in good faith, but is not necessarily dispositive. For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.

(4) Other factors. Facts and circumstances other than a corporation's legal justification may be taken into account, as appropriate, in determining whether the corporation acted with reasonable cause and in good faith with respect to a tax shelter item regardless of whether the minimum requirements of paragraph (f)(2) of this section are satisfied.

(g) Transactions between persons described in section 482 and net section 482 transfer price adjustments. [Reserved]

(h) Valuation misstatements of charitable deduction property.

(1) In general. There may be reasonable cause and good faith with respect to a portion of an underpayment that is attributable to a substantial (or gross) valuation misstatement of charitable deduction property (as defined in paragraph (h)(2) of this section) only if—

(i) The claimed value of the property was based on a qualified appraisal (as defined in paragraph (h)(2) of this section) by a qualified appraiser (as defined in paragraph (h)(2) of this section); and

(ii) In addition to obtaining a qualified appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

(2) Definitions. For purposes of this paragraph (h): *Charitable deduction property* means any property (other than money or publicly traded securities, as defined in §1.170A-13(c)(7)(xi)) contributed by the taxpayer in a contribution for which a deduction was claimed under section 170. *Qualified appraisal* means a qualified appraisal as defined in §1.170A-13(c)(3). *Qualified appraiser* means a qualified appraiser as defined in §1.170A-13(c)(5).

(3) Special rules. The rules of this paragraph (h) apply regardless of whether §1.170A-13 permits a taxpayer to claim a charitable contribution deduction for the property without obtaining a qualified appraisal. The rules of this paragraph (h) apply in addition to the generally applicable rules concerning reasonable cause and good faith.

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