IRS GUIDANCE REGARDING CIRCULAR 230—EFFECT ON ESTATE PLANNING PRACTITIONERS

July 14, 2005

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DISCUSSION

I. REVISIONS TO CIRCULAR 230

1. Revised Regulations Issued Effective May 19, 2005

Final regulations issued in December 2004 do not refer to tax shelter opinions but to “covered opinions.” There is concern that some of the requirements may apply to standard written communications between tax advisors and clients. The Department of Treasury and the IRS have received a number of comments pointing out various practical problems in implementing regulations that were issued in December 2004. Some of the comments have observed that if these rules apply to standard tax advice, giving written tax advice will become very expensive and sometimes will be unwise. That would seem to be poor public policy—to discourage taxpayers who are trying to follow the rules from getting good tax advice. Three years ago when the IRS wrote the tax shelter rules regarding “reportable transactions”, they specifically excluded estate planning transactions. That is clearly no longer the case.

In response to these comments, regulations issued on May 18, 2005 make some revisions to Circular 230 to clarify some of the problem areas. There are three additions to "excluded advice" that will not be treated as "covered opinions." The revisions also relax specific requirements for the format of a notice providing that the taxpayer cannot depend on the writing to avoid penalties. Finally, and perhaps most importantly, there is further guidance as to what constitutes a transaction "the principal purpose" of which is to avoid or evade tax.

2. Effective Date Not Extended. The effective date of the Circular 230 final regulations will continue to be June 20, 2005. Various comments requested the extension of that effective date until some of the practical issues can be resolved. The Treasury and IRS expressly declined to extend the effective date. Planners need to become acquainted with the new rules that will be effective in a matter of weeks from now.

3. Brief Summary of Additional "Excluded Advice" Provisions.

Circular 230 provides that written advice that constitutes "covered opinions" must satisfy various requirements that, as a practical matter, require that the advice be somewhat in the form of what is generally referred to as a formal legal opinion—and would be expensive to prepare in many circumstances. The revision adds three categories of "excluded advice" that will not be treated as "covered opinions." (Even though these types of written advice are not "covered opinions," they are still subject to requirements in §10.37 that apply to "other written advice.")
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a. Written Advice Issued After a Tax Return is Filed. Generally speaking, advice given after a tax return is filed, in particular advice given in the context of an IRS examination or litigation, will not constitute a covered opinion. Specifically, the definition of excluded advice is expanded to include written advice after the taxpayer has filed a tax return reflecting the tax benefits of the transaction. However, that exclusion does not apply if the practitioner knows or has reason to know the taxpayer will rely on the advice to take a position on a tax return filed after that date (including an amended return that claims benefits not reported on a previously filed return).

b. Advice By In-House Counsel. Advice by in-house counsel to the employer solely for purposes of determining the tax liability of the employer will be excluded advice, so that it will not be a covered opinion. (The preamble to the regulation goes on to say that this revision will not affect other aspects of the relationship between the in-house counsel and the employer, such as the attorney-client privilege or the impact of advice on determining the employer's good faith and reasonable cause (presumably for purposes of avoiding penalties).)

c. Negative Advice. Comments pointed out that advice to the effect that a transaction will not be effective for tax purposes should not be subject to the strict "covered opinion" requirements. The revision regulation adopts this approach, stating that excluded advice includes "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." The tax shelter rules provide various confidence levels. This revised exclusion will not apply if the advice says there is any chance of success at any confidence level.

Even if the negative advice exclusion does not apply because it reaches a favorable conclusion at a low level, the advice may still not be a covered opinion. If the advice is not a "principal purpose" advice, it is a covered opinion only if it meets one of several other circumstances, the most common of which is that it involves tax avoidance as a significant purpose and that it is a "reliance opinion" that reaches a more likely than not confidence level as to one or more significant Federal tax issues. If the advice does not reach a more likely than not confidence level as to any significant Federal tax issue, the advice is not a "reliance opinion."

4. Brief Summary of Relaxation of "Prominently Disclosed" Definition. Circular 230 has various references to a notice being "prominently disclosed." For example, an opinion that reaches a

more likely than not confidence level as to a significant Federal tax issue will still not be a "reliance opinion" if the advice contains a notice that the taxpayer cannot rely on the advice to avoid penalties. The December regulations required that the notice be "in a separate section at the beginning of the written advice in a bolded typeface that is larger than any other typeface used in the written advice." The revised regulations require more generally that the notice be "readily apparent" to the reader, which will depend on the facts and circumstances, including the sophistication of the taxpayer and the length of the written advice. The regulation goes on to specify two minimum requirements—the notice must be in a "separate section (and not in a footnote)" and in the same size or larger typeface than the rest of the advice.

5. Further Guidance Regarding Principal Purpose Test. If the written advice is about a transaction "the principal purpose" of which is the avoidance or evasion of any Federal tax, the advice is a covered opinion that must meet the strict requirements of covered opinions. It is not possible to avoid the covered opinion requirement (as it is under a significant purpose category) by having an opinion (1) that does not address any "significant" Federal tax issue, (2) that does not reach a more likely than not confidence level, or (3) by including a notice that the taxpayer cannot rely on the advice to avoid penalties. In light of the strict application of the covered opinion rules to "principal purpose" advice, the comments to the Treasury and IRS requested further guidance as to what constitutes principal purpose transactions. The preamble to the new regulation states that it adopts a definition similar to the definition in Regulation § 1.6662-4(g)(2)(ii). (This regulation is to the substantial understatement penalty special rules for tax shelters, which previously applied where "the principal purpose" was to avoid or evade Federal taxes. The statute has been revised so that it now applies if avoiding or evading Federal taxes is merely a significant purpose of the transaction, but the regulations still refer to the principal purpose test.)

The regulation is revised to provide that the principal purpose of an arrangement is avoiding or evading Federal tax "if that purpose exceeds any other purpose." The regulation then uses the standard in Regulation § 1.6662-4(g)(2)(ii) and states that the principal purpose is not to avoid or evade Federal tax if the arrangement "has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose."

II. PLANNING ISSUES IN LIGHT OF CIRCULAR 230 GUIDANCE

1. Be Prepared After June 20, 2005. This is no longer a hypothetical issue that may apply at some point in the future. There was some hope that the effective date of the regulation would be extended until some of the practical problems with the implementation of the new rules could be resolved. We now know that the extension will not happen. All tax practitioners must become very familiar with the new rules that must considered whenever the planner gives any kind of written advice.

2. Principal Purpose Test is Relaxed But Is Still a Concern for Many Transactions. Some commentators raised whether merely sending a transmittal letter describing a will with a bypass trust would be a principal purpose transaction that would be subject to the covered opinion requirements (because the IRS may determine that the principal purpose of using a bypass trust is to save estate taxes at the surviving spouse's subsequent death). The other view is that the principal purpose of most estate planning transactions is to transfer assets to family members, and the transactions are merely structured in a way to be as tax efficient as possible. The revision helps to clarify that many traditional estate planning transactions are not principal purpose test arrangements. However, the revision is not as clear as some commentators had requested. For example, some of the comments requested that the principal purpose test would apply to "reportable transactions" as defined in Code § 6011, which provides a much more objective standard. The Treasury and IRS refused that approach in favor of a much more subjective "exceeds any purpose" standard. In summary, there are still a wide variety of estate planning transactions that might possibly be subject to the principal purpose rule (such as,

possibly, written advice about family limited partnerships if a court were to determine that the main purpose—even if there were a variety of other legitimate or significant purposes—was to save taxes.)

Fortunately, the revised rule seems to make clear that many straightforward discussions of traditional estate planning strategies (such as GRATs, QPRTs, CRATs, credit shelter trusts, etc.) would not be subject to the principal purpose test. (However, some well-respected planners have already questioned whether GRATs, ILITs, or other techniques that are not *specifically* mentioned in a statute are outside the principal purpose test under this revised rule.) There will still be uncertainty, however, over some strategies that are often discussed as part of the estate planning process. The IRS has made "principal purpose" arguments in other estate planning contexts. For example, in Christophani, the IRS argued that the Crummey power in that case should be ignored because the principal purpose was tax avoidance. In various FLP cases, the IRS argued that the partnership should be ignored for transfer tax purposes because the principal purpose of the FLP was tax avoidance with no economic substance.

As an example, what if the grantor retains dispositive powers subject to an ascertainable standard as trustee of an irrevocable trust? There is no "statute and Congressional purpose" and there are no regulations approving that approach, but numerous cases have concluded that such powers do not cause estate inclusion. Would a written discussion of the estate tax effects of naming the donor of a trust as trustee with an ascertainable standard on distributions be a principal purpose transaction that is a covered opinion? Arguably, the principal purpose of that transaction is to transfer assets, and not saving taxes, but the revised guidance for the principal purpose test does not itself suggest that a desire to transfer assets would supercede the desire to do so in a tax efficient manner.

Another example is written advice about the estate planning effects of creating a family limited partnership. Recent Tax Court cases (Bongard, Bigelow, and Korby) have concluded that there was not a legitimate and significant nontax reason for creating the partnership in those cases. Those courts would conceivably conclude that the tax savings features of the family limited partnership in those cases "exceed any other purpose." If a written summary about the estate planning effects of a family limited partnership is deemed to come under the principal purpose test, it would be a covered opinion. Among other things, it would have to include a full discussion of the applicable law "(including potentially applicable judicial doctrines)."

Another situation that might possibly come under the principal purpose test is a sale to a grantor trust, particularly where the grantor trust was created for the purpose of the sale transaction. Arguments could go both ways on whether that is a principal purpose transaction in light of the fact that there is no specific "statute or Congressional purpose" about that transaction.
It is comforting that informal comments over the last month by Treasury and IRS officials indicate that the principal purpose test was intended to apply to egregious situations. For example, Cono Namorato, director of the IRS Office of Professional Responsibility was quoted in Tax Notes (May 2, 2005) as follows:

> "Namorato said the IRS had likely received the most feedback from the public about the definition of the phrase 'principal purpose of tax avoidance or evasion." The rules are generally meant for 'fringe behavior involving tax scams and schemes,' and clarifying language is on the way, Namorato said."

Unfortunately, the revised language of the regulation does not specifically define the principal purpose rule in terms of fringe behavior involving tax scams and schemes.

3. Significant Purpose Transactions— Determine Whether the Advice is a More Likely Than Not Confidence Level, Determine If There is a "Significant" Federal Tax Issue, and Weigh Whether to Include Penalty Disclaimer Notice. Many estate planning transactions involve some element of tax savings, and may very well be treated as significant purpose transactions. Written advice

about significant purpose transactions is treated as a covered opinion only if the writing is in one of several categories, the most important (to estate planners) of which is the "reliance opinion." A writing is a "reliance opinion" only if (1) it reaches a more likely than not confidence level as to a "significant" Federal tax issue and (2) if does not have a notice stating that the taxpayer cannot rely on the written advice to avoid penalties.

a. More Likely Than Not Confidence Level. Communications by estate planning practitioners do not typically contain "more likely than not" language. That phrase is used in the tax shelter penalty rules and is typically not used in common communications about tax matters. The concern, however, is that advice about the tax effects of a transaction may implicitly carry a "more likely than not" confidence level.

A possible planning strategy may be to use the words "substantial authority" or "reasonable basis" in the conclusion of the written advice. The practitioner could then, if questioned, maintain that the advice did not rise to a "more likely than not" confidence level. As a practical matter, the taxpayer may not be aware of (and may not care about) the technical difference between these terms.

b. Significant Federal Tax Issue. Under the regulations, a Federal tax issue is significant if the IRS has a reasonable basis for a successful challenge and its resolution could have a significant impact on the overall Federal tax treatment of the transaction. §10.35(b)(3). Many estate planning transactions have clear cut tax effects that will not raise a "significant" Federal tax issue under this definition, requiring that the IRS have a reasonable basis for a successful challenge. If that is the case, the advice is not a covered opinion.

As an example, the description of a "standard" GRAT may arguably not involve a "significant" tax issue because the IRS would have no reasonable basis for a successful challenge. However, there may sometimes be issues that could be raised. For example, could the IRS reasonably attack a zeroed out GRAT? Could a two or three year GRAT be reasonably attacked? Even a description of a bypass trust could involve issues where there is a reasonable basis of a successful challenge if the plan deviates any at all from accepted straightforward arrangements. Another example—"How much can I give under the annual exclusion?" Answer $11,000. But that answer assumes no prior gifts, assumes no birthday gifts and no meals bought for the family member, etc., and it assumes the gift will qualify for the annual exclusion. It would seem that issues might be raised frequently as to whether the IRS has a reasonable basis to question the advice under some situations. The practitioner will have to make a judgment with respect to every written advice as to whether a "significant" tax issue exists.

c. Consider Whether to Include Penalty Disclaimer Notice. If the writing does involve an issue that is not totally clear from a tax perspective, the planner must then address with the client whether to include a notice "in a separate section" that the taxpayer cannot rely on the advice to avoid penalties. If the notice is included, the advice is not a covered opinion subject to the strict requirements for covered opinions. If that is not acceptable to the client, Circular 230 says that the tax practitioner is prohibited from giving the written advice unless it meets all of the formal requirements for a covered opinion. Up to now, some planners have scoffed at the prospect of including a "you can't rely on this" notice on their advice. There is concern that clients may not be very understanding about paying (handsomely) for advice that cannot be relied on. On the other hand, the disclaimer notice may become so commonplace that clients ignore it as a practical matter. That is no longer a theoretical question. Planners will have to focus on this issue with clients as to written advice about any issues where there are not clear tax effects and where the IRS could "reasonably" raise a challenge.

4. Address Oversight Responsibility. Circular 230 requires that each practitioner who has principal authority for overseeing a firm's practice of providing Federal tax advice must take reasonable steps to ensure the firm has adequate procedures in effect for all members and employees for complying with the Circular 230 requirements. § 10.36(a). Failure to meet these

requirements could lead to fines, censure, suspension or disbarment of the oversight practitioner from practicing before the IRS. Therefore, it is not enough for each individual practitioner to be sensitive to the new rules in his or her daily practice whenever any writing is sent to a client. The firm must adopt a procedure for ensuring that everyone in the firm (even persons who are not in the tax section of the firm) complies with these requirements. At the far end of the spectrum, some firms have considered whether to require including a "no reliance to avoid tax penalties" on all written advice unless formal approval is received from the firm in a particular situation to do otherwise. In any event, the firm must take "reasonable steps" to consider what "adequate procedures" will be adopted to ensure compliance with the new rules.

III. BACKGROUND ABOUT CIRCULAR 230 CONCERNS FOR ESTATE PLANNING ATTORNEYS

1. Overview Summary of Circular 230.

a. History and Overview. Circular 230 was first issued in 1921. It contains the standards of practice before the IRS and is authorized by an 1884 statute. It has been revised substantially in the last several years regarding tax shelters. Under the tax shelter rules, the taxpayer must file a Form 8836 for any reportable transaction. Under the reportable transaction regulations, no estate or gift tax matter was covered unless it was a listed transaction. Final regulations were issued in December 2004 that came as a huge surprise in expanding Circular 230 considerably beyond tax shelters. The proposed notice of changes to Circular 230 referred explicitly to tax shelters. However, the final regulations do not refer to tax shelter opinions, but rather to "covered opinions." There is concern that some of the requirements may apply to standard written communications between tax advisors and clients.

There are "best practices" that are applicable to all advisors. (§10.33) While the "best practices" are not mandatory, it is possible that the plaintiff in any malpractice action would point to any failures of a practitioner to meet the best practices.

There are mandatory strict standards for "covered opinions."

Sanctions include penalties, censure, suspension or disbarment from practicing before the IRS.

The effective date of the new regulation is June 20, 2005.

b. Written Advice. The standards apply to "written advice," which includes email. Written advice is not limited to formal legal opinions, but includes any writings.

c. Covered Opinions (§10.35(b)(2)). The strict standards apply to "covered opinions." This is a precisely defined term that includes any written advice (including emails) concerning one or more "Federal tax issues" (a defined term) arising from:

(1) a listed transaction [these are tax shelter transactions that the IRS has previously identified];

(2) any plan or arrangement where avoidance or evasion of any tax is **the *principal purpose*** (meaning that the tax savings purpose exceeds any other purpose; not including claiming tax benefits consistent with "the statute and Congressional purpose");

(3) any plan or arrangement where avoidance or evasion of tax is **a *significant purpose***, if the written advice is:

(a) a reliance opinion, which is written advice that concludes at a confidence level of at least more likely than not that one or more significant Federal tax issues would be resolved in the taxpayer's favor. A tax issue is "significant" if the IRS has a reasonable basis for a

successful challenge and the issue could have a significant impact on the overall tax treatment of the transaction. The writing will not be treated as a “reliance opinion” if it has a “prominently disclosed” disclaimer that it was not written to be used and cannot be used for the purpose of avoiding penalties. To be “prominently disclosed” the disclosure must be readily apparent to the reader determined in the particular facts and circumstances, and at a minimum must be in a separate section in the same or larger typeface as compared to the rest of the written advice. [Observe, this “disclaimer” exception only applies for reliance opinions and not any of the other types of written advice.]

(b) a marketed opinion (the practitioner knows or has reason to know the written advice will be used or referred to by someone else in promoting, marketing, or recommending an arrangement to a taxpayer). There is an exception if the practitioner “prominently discloses” that (x) it cannot be used to avoid penalties, (y) that the advice was written to support the promotion or marketing of the matters addressed, and (z) the taxpayer should seek advice from an independent tax advisor.

(c) subject to conditions of confidentiality (meaning the advice is subject to conditions of confidentiality, regardless of whether that restriction is legally binding); or

(d) subject to contractual protection (meaning that the taxpayer has a right to a partial or full refund if the intended tax consequences are not achieved, or if fees are contingent on realization of tax benefits from the transaction).

[Observation: The most important of these alternatives to estate planners is the reliance opinion category. It might seem that many written communications between tax advisors and estate planning clients would not meet the category of “reliance opinions” because they do not specifically have an explicit “more likely than not” conclusion. However, there is concern that a letter that merely summarizes the tax effects of a transaction, without more, carries a “more likely than not” conclusion by implication. Even if the advice does include a “more likely than not” confidence level of prevailing on tax issues, the advice will still avoid being classified as a reliance opinion if a disclaimer is included. (However, the client then could not rely on the communication to establish good faith or reasonableness for the purpose of avoiding tax penalties.)]

d. Excluded Advice (§10.35(b)(2)(ii)). Certain advice is excluded from being a covered opinion. This includes (1) preliminary advice, where the practitioner reasonably expects to provide subsequent written advice that satisfies the requirements of Circular 230, (2) advice regarding qualified plans, state or local bonds, or SEC documents, (3) advice after the taxpayer has filed a tax return, (4) advice by in-house counsel regarding tax liability of the employer, and (4) negative advice that does not advise a positive tax result at any confidence level.

e. Requirements for Covered Opinions (§10.35(c)). If a written advice is a “covered opinion” as defined above, there are various strict requirements that the writing must meet. These requirements include:

- The practitioner must use reasonable efforts to identify and ascertain the facts [Observation: It may not be sufficient just to rely on what the client tells the practitioner];
- The practitioner must not base the opinion on any unreasonable factual assumptions or representations;
- The opinion must relate the applicable law (including “potentially applicable judicial doctrines”), and may not assume the favorable resolution of any significant federal tax issue (except in the case of a “limited scope opinion”);
- The opinion must evaluate all “significant federal tax issues” and reach a conclusion, supported by the facts and the law, as to the likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue; (Observation: Does that mean that the advice must come to a 60%, 65%, etc. likelihood as to each issue?)

- If there is *any* issue that the practitioner cannot reach a more likely than not conclusion, the advice must say that and have a banner that the opinion could not reach "more likely than not" on all issues.
- The evaluation of significant federal tax issues must not consider the possibility that a return will not be audited, that an issue will not be raised on audit, or if it is, that the issue will be settled;
- For marketed opinions, the opinion must reach a more likely than not confidence level on *every* significant federal tax issue or else the market opinion cannot be given (unless it complies with the waiver exception described above for marketed opinions).

[Observe, these various elements are generally included in "formal" legal opinions that are very time demanding to prepare and very expensive. If the tax advisor is not giving a formal opinion letter, the advisor probably will not want to include an exhaustive analysis of all significant tax issues in many informal client communications. If not, it would be important to avoid having the advice classified as a "covered opinion."]

f. Responsible Tax Practitioner Must Establish Procedures to Assure Compliance (§10.36). The practitioner who has principal authority for overseeing a firm's tax practice must, subject to discipline for noncompliance, take reasonable steps to assure that all employees comply with the covered opinion requirements.

g. General Standards for Written Advice That is Not A Covered Opinion (§10.37). (Observe, this applies to ALL written advice.) A practitioner cannot provide written advice if he or she (1) bases it on unreasonable factual or legal assumptions; (2) unreasonably relies on representations of the taxpayer or others; (3) fails to consider relevant facts; or (4) takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled. [Accordingly, written communications should never refer to "audit lottery" or settlement types of considerations.] Broad circumstances will be considered in determining whether a practitioner has failed to comply with these requirements.

The requirements under §10.37 for "other written advice" have been made more stringent by the final regulations that were issued in December. That section applies to written advice covering "one or more Federal tax issues"—not just if there are *significant* federal tax issues. Those rules would clearly seem to apply to all written advice given by estate planning attorneys where there are any tax issues at all. The requirements include that the advice is not based on unreasonable factual or legal assumptions or reliance on representations, and that the practitioner must consider all relevant facts that the practitioner knows "or should know" in evaluating a tax issue. Will strict due diligence requirements be applied to attorneys in giving routine tax advice? In addition, it appears that the writing cannot "take into account" whether a transaction can be structured in a way that creates less of a "red flag" to the IRS, and cannot address the likelihood of an IRS settlement.

2. Attempt to Increase Standard for Reliance to Avoid Penalties? A taxpayer can avoid penalties if there is merely a reasonable basis for its position. There is no requirement of a "more likely than not" confidence level to avoid penalties (except for income tax purposes when dealing with tax shelters).

Under Circular 230, however, if written advice is a "covered opinion," the regulation effectively applies a more likely than not requirement to avoid penalties. (1) §10.35(c)(3)(ii) says that if the practitioner fails to reach a more likely than not confidence level as to *any* significant federal tax issue, the opinion must include disclosures required under paragraph (e). (2) §10.35(e)(4) says that a covered opinion that fails to reach a more likely than not conclusion with respect to any significant Federal tax issue must disclose that the opinion does not reach a more likely than not confidence as to one or more significant tax issues and "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."