

**COMMENTS ON FINAL REGULATIONS ISSUED UNDER CIRCULAR
230 OF THE AMERICAN BAR ASSOCIATION SECTION OF REAL
PROPERTY, PROBATE AND TRUST LAW**

The following comments are being submitted on behalf of the American Bar Association Section of Real Property, Probate and Trust Law. They have not been approved by the House of Delegates nor the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

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Although many of the members of the Section of Real Property, Probate and Trust Law who participated in the preparation of these comments necessarily have clients affected by federal taxation, including the federal tax rules applied in the subject area addressed by these comments, no such members (or the firm of such member) has been engaged by a client with respect to the specific subject matter of these comments.

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INTRODUCTION

The Department of Treasury (“Treasury”) and the Internal Revenue Service (the “IRS”) appropriately have used their ability to regulate the practice of attorneys and other tax professionals before the IRS under Title 31, CFR Subtitle A, Part 10, commonly known as “Circular 230,” as one means of curbing abusive tax practices. On December 30, 2003, Treasury promulgated proposed regulations (the “Proposed Regulations”) under Circular 230 which focused primarily on tax advice related to tax shelter transactions and subjected practitioners to a stricter standard for providing “more likely than not” opinions and marketed opinions. On December 20, 2004, after receiving many comments from practitioners on the Proposed Regulations, Treasury promulgated final regulations (the “Final Regulations”) under Circular 230. Unlike the Proposed Regulations, the Final Regulations address much broader types of written advice than just “more likely than not” opinions and marketed opinions. Unless the Final Regulations are modified to provide relief, practitioners will be required after June 20, 2005 (the effective date of the Final Regulations) either to prepare most of the written tax advice in the form of a “covered opinion” similar in form to that currently used to provide formal opinions of law, or to include at the outset of all letters, emails and other informal written advice certain “disclaimer” language the meaning of which clients may or may not understand.¹

Background. The Proposed Regulations amended the proposed regulations issued in 2001 under Circular 230. The purpose of the 2001 proposed regulations was to curb the proliferation of abusive tax practices which are commonly referred to as “tax shelters.” The Proposed Regulations targeted tax shelter opinions which were defined as “any written advice by a practitioner concerning the Federal tax aspects of any Federal tax issue relating to a tax shelter item.” A tax shelter item was defined as “an item of income, gain, loss, deduction or credit, the existence or absence of a taxable transfer of property or the value of property with respect to a tax shelter.” A tax shelter was defined in the Proposed Regulations as “any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which was the avoidance or evasion of any tax imposed by the Internal Revenue Code”. In the Final Regulations, *any* written advice (not just “more likely than not” opinions or marketed opinions) must be in the form of a covered opinion if the advice is related to a transaction that is a listed transaction or one in which the principal purpose is tax avoidance or evasion. Even written advice related to a transaction a significant purpose of which is tax avoidance or tax evasion must be in the form of a covered opinion, unless an exception applies.

In addition to the issuance of the Proposed Regulations, Treasury also promulgated regulations under Code § 6011² that provide an objective definition of a tax shelter (a “reportable transaction”) and impose certain reporting requirements on taxpayers who participate in reportable transactions. Treasury also promulgated regulations under Code § 6012 which require

¹ As discussed below, this “disclaimer” option is of limited use, as it is not viable for advice concerning listed transactions or transactions the principal purpose of which is tax avoidance or evasion.

² References to “Code §” are to the Internal Revenue Code of 1986, as amended, references to “Treas. Reg. §” are to sections of the Treasury Regulations under the Code and references to “Section” are to sections of the Final Regulations.

certain advisors whose clients participate in tax shelters to maintain a list of such taxpayers that must be disclosed to the IRS upon request. In addition, Treasury promulgated regulations under Treas. Reg. §§ 1.6662-2, 1.6662-3, and 1.6662-4 regarding the effect of a failure to comply with the tax shelter disclosure requirements set forth in Code § 6011 on a taxpayer's ability to avoid the accuracy-related penalty for a substantial underpayment of tax. The regulations under Code §§ 6011, 6012 and 6662, and the Proposed Regulations, together with the IRS's successful attacks in the courts on the attorney/accountant privilege, as well as certain injunctive powers provided by Congress, provided the IRS with a powerful arsenal to use against tax shelters and the promotion of tax shelters.

The Final Regulations. The Final Regulations, however, substantially expanded the applicability of the requirement of a covered opinion or disclaimer language beyond the area of tax shelters. The requirements for a covered opinion or disclaimer language set forth in the Final Regulations are now applied to all written tax advice that clients request from practitioners if the principal purpose of a transaction on which advice is sought is tax avoidance or evasion ("principal purpose transactions"); if the transaction on which the advice is sought is a listed transaction; or, if a significant purpose of the transaction on which advice is sought is tax avoidance or evasion if such "significant purpose" advice is in the form of a reliance opinion involving a "significant federal tax issue", a marketed opinion, advice issued under conditions of confidentiality or advice issued with contractual provisions ("significant purpose transactions"), unless the exception for certain transactions set forth in the Final Regulations applies. Significant purpose transaction advice does not have to be in the form of a covered opinion if such advice carries certain disclaimer language at the outset, but there is no such exception for principal purpose transaction advice and listed transaction advice (regardless of when the advice is rendered or the context in which it is sought).

The requirements under the Final Regulations have the effect of reaching the day-to-day communications between a practitioner and client that involve tax advice on transactions that are not abusive, although the principal purpose of which may be tax avoidance, such as, for example, a recommendation to a client to exchange (rather than sell) investment real estate in a Code § 1031 like-kind exchange, or to give appreciated stock to a charity, rather than selling it and giving the proceeds to charity.

If a practitioner is required to produce a covered opinion every time a client requests tax advice or to prominently display disclaimers prior to providing such advice, the practitioner will be prevented from acting as an effective resource for and counsel to the client. As written, the Final Regulations will inhibit the relationship between the practitioner and the client and will not promote confidence in the tax bar; in fact it will accomplish just the opposite. Clients will fear that they cannot rely on their practitioner to offer them advice without producing a document that is formalistic and expensive; or, in the alternative, that they cannot rely on the practitioner's advice due to the existence of the disclaimer language that is prominently displayed. These fears will result in a lack of confidence in the practitioner and the inevitable conclusion that such advice was written, whether as a covered opinion or with disclaimers, to protect the practitioner and not the client. Because of the provisions of the Final Regulations, some clients may choose to forgo advice rather than seek (and pay for) what might be a covered opinion. The Final Regulations may therefore *reduce* voluntary tax compliance by increasing the chances a taxpayer

might take a risky return position which a practitioner could easily have counseled against in an informal written communication.

The IRS has expressed a goal of “rein[ing] in practitioners who disregard their ethical obligations” and of ensuring that such practitioners adhere to professional standards and adhere to the law.³ The Final Regulations may require that practitioners communicate written advice in a formalistic manner, but they will not achieve the stated IRS goal. The Final Regulations will instead cause practitioners to be wary of providing their clients with any written advice for fear of running afoul of the Final Regulations, which will be contrary to another IRS goal of providing clients with “the highest quality representation.” (See Section 10.33.) Although IRS representatives have urged a “common sense” approach to the interpretation of the Final Regulations,⁴ it is not practical for practitioners to rely on such a recommendation for fear that an inadvertent violation of the Final Regulations will give rise to an ethics violation under state law or will be “cited by plaintiffs’ lawyers in suits against tax lawyers....”⁵ A more realistic solution to meet the IRS goal would be for the Final Regulations to contain reasonable restrictions that can be interpreted objectively. We therefore request that the requirements of the Final Regulations be revised to limit the situations when a covered opinion or the disclaimer language is required and to provide greater clarity with respect to the written tax advice that must be in the form of a “covered opinion.”

The revisions to the Final Regulations recommended herein are designed to preserve the day-to-day written communications that are provided to a client from a practitioner and which facilitate taxpayers’ voluntary compliance and permit taxpayers to engage in non-abusive transactions with the comfort of knowing the tax consequences they may expect. These recommendations are not designed to protect abusive tax practices or to provide a means of providing penalty protection to a client other than in the form of a covered opinion. The overall goals of the Final Regulations, which are to curb abusive transactions and restore public confidence in practitioners, will continue to be achieved, and even enhanced, if these revisions are accepted. These goals are appropriate and should be developed under Circular 230. However, the Final Regulations, in their current form, by applying the requirement of a covered opinion or disclaimer language to written tax advice provided in situations where there is no evidence of abusive tax practices, in these situations will impede rather than achieve these goals.

SUMMARY OF RECOMMENDATIONS

Accordingly, we make the following recommendations:

1. Extend the effective date. Extend the effective date of the Final Regulations to provide sufficient time for practitioners to address the requirements of the Final Regulations as they may be modified after Treasury and the IRS have had an opportunity to consider the comments they

³ “IRS and the Treasury Department Amend Circular 230 to Promote Ethical Practice by Tax Professionals,” December 17, 2004, IR-2004-152, IRS News Release.

⁴ “Government Urges Common Sense Approach to Circular 230 Regs.” Sheryl Stratton, February 10, 2005, Tax Analysts, 2005 TNT 27-1.

⁵ Citing a staff attorney for Attorney Liability Assurance Society in “Circular 230 Rules Examined at D.C. Bar Tax Section Meeting” Sheryl Stratton, February 3, 2005, Tax Analysts, 2005 TNT 22-3.

receive. This extension will decrease the number of inadvertent violations of the requirements of the Final Regulations.

2. Reasonably limit the scope of the “covered opinion” definition. Limit the applicability of the requirements for covered opinions in one of two ways, which will still allow the IRS to meet its stated goals for reducing abusive transactions.

First alternative - limit covered opinions to reportable transactions and marketed opinions. Limiting “covered opinions” to advice concerning a reportable transaction (without regard to minimum fees for confidential transactions), as defined in Code § 6011 and referred to in the Final Regulations issued under Code §§ 6012 and 6662, and to certain types of marketed opinions (as set forth below) will provide practitioners with a clearer set of rules and will achieve another important goal of Treasury and the IRS, namely, tax simplification.

Second alternative - eliminate the distinction between “principal” and “significant” purpose transactions. If the Final Regulations are not limited as described above, then eliminating the distinction between principal purpose transaction advice and significant purpose transaction advice would give practitioners a single set of rules to follow without distinctions based on immeasurable levels of taxpayer intent.

3. Permit “opting out” of Section 10.35. Expand the provisions currently contained in the Final Regulations that permit “opting out” of a covered opinion requirement, either by setting forth certain disclaimers at the outset of each item of written tax advice, or only once in the engagement letter provided to the client at the outset of the engagement.

4. Revise “marketed opinion” definition. Revise the definition of a marketed opinion (which under our recommendations will remain subject to the requirements of the Final Regulations) to exclude general information provided in a practitioner’s outlines and articles prepared for other professionals, professional “listserv” communications, articles provided to clients for their information or knowledge, or materials prepared for dissemination to others without attribution to the practitioner.

5. Clarify firm oversight requirements. Clarify that the head of the tax practice can meet the requirements of implementing procedures to ensure compliance with the requirements for covered opinions through education of the other lawyers and legal staff of the firm on the requirements for a covered opinion and will not be held responsible for the actions of other lawyers and legal staff of the firm who do not practice before the IRS. To require any practitioner to be responsible for what another person sends to a client will restrict the free-flow of communication among all practitioners within a firm as well as between any practitioner and his or her clients.

6. Exclude certain post-transaction and negative advice. Expressly state that negative advice, when a client is advised against entering into a transaction, will not come within the purview of the Final Regulations’ requirements. Although at various times members of the IRS and Treasury have expressed this intent, the fear of the consequences of an inadvertent violation of the Final Regulations renders this verbally stated intent ineffective.

7. **Clarify the restrictions on risks of audit advice.** Exclude practitioners' written discussions of audit risk with clients, when not made in the context of evaluating the transaction itself. Once the practitioner has reached a conclusion about a transaction based on the relevant law and facts of the transaction, the practitioner should be allowed to explain to the client the risks of such a transaction, including the consequences, and costs, if the transaction were to be audited.

RECOMMENDATION 1 – EXTEND THE EFFECTIVE DATE OF THE FINAL REGULATIONS

Relevant Circular 230 Provisions. Sections 10.33(c), 10.35(g), 10.36(b), 10.37(b) and 10.52(b) provide that the Final Regulations are applicable after June 20, 2005.

Problems. Many questions have been raised about the scope of the Final Regulations. Government representatives have indicated that the Final Regulations might lead to results which were not intended, but the government thankfully has also expressed a willingness to consider comments by tax practitioners to identify advice that should not be subject to the Final Regulations. The Final Regulations are currently much more expansive than the Proposed Regulations and can apply to informal written advice provided by the practitioner (even advice discouraging a client from entering into a particular transaction). Many practitioners will inadvertently violate the Final Regulations unless and until more guidance is provided. Significant time and expense will have been unnecessarily incurred by practitioners preparing to meet the requirements of the Final Regulations if their applicability is modified following the government's review of practitioners' comments.

In the interim, the Final Regulations might cause unintended consequences. An inadvertent violation could raise ethical issues on the state level, be argued by a plaintiff's lawyer as a breach of the standard of care, or expose the head of a firm's tax practice to disciplinary action under the Final Regulations. The many questions raised by the Final Regulations can also lead to confusion in the area of tax practice.

Suggested Solution. Many questions have been raised, and the government has indicated a willingness to listen to input from practitioners regarding the scope of the Final Regulations. We therefore recommend that the effective date of the Final Regulations be extended to provide sufficient time for practitioners to address the requirements of the Final Regulations as they may be modified after Treasury and the IRS have had an opportunity to consider the comments they receive.

RECOMMENDATION 2 - CLARIFY THE SCOPE OF "COVERED OPINION" DEFINITION

Relevant Circular 230 Provisions. Section 10.35(b)(2)(i) provides that, in general, a "covered opinion" is written advice, including email communications, by a practitioner concerning one or more Federal tax issues arising from:

- a. A listed transaction under Treas. Reg. § 1.6011-4(b)(2) or a transaction the same as or substantially similar to a listed transaction;

- b. An entity, plan or arrangement that has the principal purpose of avoiding or evading any tax imposed by the Code; or
- c. An entity, plan or arrangement that has a significant purpose of avoiding or evading any tax imposed by the Code, but only if the written advice is:
 - i. a reliance opinion;
 - ii. a marketed opinion;
 - iii. subject to conditions of confidentiality; or
 - iv. subject to contractual protection.

Section 10.35(b)(3) defines a Federal tax issue as any issue that concerns 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. A significant Federal tax issue is any issue as to which the IRS has a reasonable basis for a successful challenge of a result favorable to the taxpayer and the resolution of the challenge could have a significant impact on the overall Federal tax treatment of the transaction addressed in the written advice.

Section 10.35(b)(4) defines a reliance opinion as written advice concerning a significant purpose transaction that concludes there is a greater than 50 percent likelihood that a significant Federal tax issue would be resolved in the taxpayer's favor unless the written advice prominently discloses that it cannot be used by the taxpayer for the purpose of avoiding tax penalties.

Section 10.35(b)(5) defines a marketed opinion as written advice concerning a significant purpose transaction that the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner or a person associated with the practitioner's firm in promoting, marketing or recommending an entity, plan or arrangement to one or more taxpayers unless the advice prominently discloses that (i) it cannot be used by the taxpayer for the purpose of avoiding penalties, (ii) it was written to support the promotion or marketing of the transaction described and (iii) the taxpayer should seek tax advice concerning the transaction from an independent tax advisor.

Section 10.35(b)(6) provides that written advice is subject to conditions of confidentiality if the practitioner providing the advice imposes on one or more recipients a limitation on disclosure of the tax treatment or structure of the transaction, and the limitation protects the confidentiality of the practitioner's tax strategies.

Section 10.35(b)(7) provides that written advice is subject to contractual protection if the practitioner (or a person associated with his or her firm) is obligated to fully or partially refund fees if the intended tax results are not sustained or if the collection of fees is contingent on the taxpayer's enjoying the predicted tax benefits from the transaction.

Problems. The Final Regulations would add an additional set of definitions on top of those with which practitioners must already be familiar to avoid transactions which the IRS considers

abusive. The use of multiple definitions of what the IRS and Treasury considers to be abusive transactions will lead to confusion on the part of taxpayers and practitioners, a lack of clarity about tax policy on the part of the IRS and a more complicated, rather than simplified, tax system.

If the Final Regulations are not modified as suggested below to tie “covered opinions” to reportable transactions and marketed opinions, any written advice that relates to a principal purpose transaction is a covered opinion and must meet all of the requirements of a covered opinion. The regulations do not provide any exceptions to this rule. On the other hand, written advice that relates to a significant purpose transaction is a covered opinion only if it is a reliance opinion, a marketed opinion, is subject to conditions of confidentiality or is subject to contractual protection and, under certain circumstances, the practitioner may elect out of covered opinion status by prominently disclosing a legend on the advice providing required disclosures. While the election out procedure is a fundamental and important exception to the requirements to allow practitioners to communicate informally with their clients, its unavailability for written advice concerning principal purpose transactions creates substantially different requirements for the two types of advice. The difficulty is that the Final Regulations do not provide any guidance on determining the meaning of a “principal” purpose as distinguished from a “significant” purpose to permit the practitioner to knowingly apply the appropriate requirements to his or her written advice. If the practitioner believes that the transaction described in the written advice he or she is preparing is a significant purpose transaction, the practitioner may make the required disclosure on the written advice and believe that the requirements of the Final Regulations have been met. If, however, it is subsequently determined that the transaction was a principal purpose transaction, the practitioner will have violated the requirements of the Final Regulations since no election out of covered opinion status through the prominent disclosure requirements could have applied to the advice. This is an unacceptable risk which will result in practitioners erring on the side of considering transactions to be principal purpose transactions and requiring their clients to incur the additional delay and expense necessary for the practitioner to prepare a covered opinion – or simply to rely on oral advice.

The distinction between “principal” and “significant” purposes is not necessarily obvious. In most transactions, a number of purposes are being served. It likely will be difficult to rank all of them in terms of their relative importance in every transaction in order to determine if the principal purpose is tax avoidance. Moreover, such a ranking is at bottom a judgment call about which different practitioners or persons serving in the government may not always agree. In addition, many situations about which practitioners provide advice are part of an ongoing series of transactions as the taxpayers’ needs and circumstances change. The Final Regulations do not make clear where the line for determining the scope of a transaction should be drawn. For example, as a part of developing a client’s estate plan, a practitioner may determine that the client’s estate will lack sufficient liquidity to pay estate taxes when they become due and suggest that the client consider the use of an insurance policy to provide the required liquidity. Assuming the client agrees with this approach, the practitioner may then recommend that the client create an irrevocable trust for the purpose of purchasing the insurance to avoid inclusion of the insurance proceeds in the client’s taxable estate. If the transaction is considered to be estate planning for the client, then creation of the irrevocable trust, along with drafting the client’s Will, does not have as its principal purpose the avoidance of tax. If, on the other hand, the creation of

the irrevocable trust is a transaction which must be evaluated alone, the transaction may well be considered to have the principal purpose of tax avoidance.

Suggested Solutions .

First Alternative Solution – Define Covered Opinion to apply to Reportable Transactions and Marketed Opinions

We recommend that the definitions relevant to the covered opinion requirements of the Final Regulations should be revised to be unified with the definitions related to “reportable transactions,”⁶ so that covered opinions will consist of written advice concerning reportable transactions, with a few minor revisions. First, the requirement for a minimum fee in the definition of a confidential transaction should be eliminated for purposes of the Final Regulations. Second, any “marketed opinion” (revised as suggested below) should be a “covered opinion.”

We therefore recommend that Section 10.35(b)(2)(i) be revised to read as follows:

(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 *reportable transaction* or which is a *marketed opinion*. For purposes of this definition, *reportable transaction* shall have the same meaning as defined in 26 CFR 1.6011-4(b), except that the minimum fee in 26 CFR 1.6011-4(b)(3)(iii) shall be zero.

Guidance on the definition of a reportable transaction that is developed under either Code § 6011 or the Final Regulations would apply to both Code § 6011 and the Final Regulations. In addition, as a result of references in the Final Regulations under Code §§ 6012 and 6662 to reportable transactions, as defined in the Final Regulations under Code § 6011, any such guidance on the definition of reportable transactions issued under Code §§ 6011, 6012 or 6662, or issued under the Final Regulations, will apply to the sections of the Code or the Final Regulations, as the case may be, as well.

Second Alternative - Eliminate Distinction Between “Principal Purpose” and “Significant Purpose” Transactions.

We recommend that, if the definition of a covered opinion is not modified to be consistent with Code § 6011 as suggested above, the distinction between principal purpose transactions and significant purpose transactions in the Final Regulations be eliminated and the standards that apply to significant purpose transactions be made applicable to all transactions that have either the principal or a significant purpose of tax avoidance or evasion. In this case, a covered opinion would be written advice, including email, by a practitioner concerning one or more Federal tax

⁶ The IRS has identified several categories of “reportable transactions,” in the Final Regulations of section 6011 which encompass tax shelters as well as transactions which may or may not be abusive but are promoted by certain “advisors” with the assurance that the client will receive penalty protection if such transactions should fail. Reportable transactions include “listed transactions,” “confidential transactions,” “transactions with contractual protection,” “loss transactions,” “transactions with a significant book-tax difference,” and “transactions involving a brief asset holding period.” Treas. Reg. § 1.6011-4(b)(1) – (7).

issues arising from any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement which has as its principal purpose or as a significant purpose the avoidance or evasion of any tax imposed by the Code if the written advice is (i) a reliance opinion, (ii) a marketed opinion, (iii) is subject to conditions of confidentiality, or (iv) is subject to contractual protection. Under this modification, the definition of a reliance opinion would not change and a practitioner would have the ability to avoid covered opinion status through the use of proper disclosures. However, the taxpayer could not use the written advice to avoid the application of penalties if such disclosures were made, regardless of whether the transaction had the principal purpose or a significant purpose of tax avoidance or tax evasion. Marketed opinions would also be subject to the same requirements that taxpayers could not use them to avoid the application of penalties if the proper disclosures were made, although recommendations to narrow the scope of marketed opinions are made below. The limitations with regard to written advice that is subject to conditions of confidentiality or to contractual protections would also continue to apply.

We believe that this change will not compromise the objectives of the Final Regulations and will permit practitioners to provide needed tax advice to their clients without undue confusion and unnecessary expense. Moreover, the change is consistent with other changes to the Code. (*See, e.g., 1997 amendment to Code § 6662(d)(2)(C)*).

RECOMMENDATION 3 - MODIFY THE DISCLOSURE REQUIRED TO ELECT-OUT OF COVERED OPINION REQUIREMENTS

Relevant Circular 230 Provisions. Sections 10.35(b)(4)(ii) and (b)(8) allow a practitioner to elect out of covered opinion treatment for written advice other than that concerning a listed transaction or a transaction the principal purpose of which is the avoidance or evasion of any tax imposed by the Code. In order to achieve this result, the written advice must include a prominently disclosed statement that the advice is not intended or written by the practitioner to be used, and cannot be used by the taxpayer to avoid tax penalties. In order to be prominently disclosed, this statement must 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.

Problem Practitioners have expressed strong concern about this required approach for electing out of the covered opinion status. The inclusion of this type of statement in all written advice, including numerous otherwise routine written communications between practitioners and their clients, will be unnecessarily and excessively disruptive and burdensome. The difficulties arise not just because this statement must be used frequently and repetitively for the same client, but because it must be prominently disclosed each time. For many non-institutional clients, the required statement in multiple communications will cause significant and unproductive alarm and will undermine the relationships between clients and practitioners. The requirements of typeface and location are inconsistent and difficult to implement with today's forms of communication such as email, particularly when used from a portable hand-held device such as a Blackberry.

Suggested Solutions. We believe that there are several modifications that should be made to the disclosure requirements for electing out of covered opinion treatment. We believe these modifications will address the public's concerns, without undermining the goal of improved

compliance. At a minimum, a practitioner should be permitted to satisfy the disclosure requirement by using a single, general election out of covered opinion treatment for all future written advice given to the client which is intended only for the client's use (and which does not constitute a marketed opinion). This general election would be contained in either an engagement letter or another significant written communication that is received and signed by the client. The terms of the general election would clearly state that the client cannot use future written advice from the practitioner to avoid tax penalties, unless and until this general election is reversed by another written communication between the practitioner and the client. If the election is reversed, the reversal would only apply to future written communications. Under this approach, if a taxpayer claims that a practitioner's written advice qualifies as a reliance opinion, Treasury and the Service would have the right to require a certification by the practitioner that there was not an effective election out of covered opinion treatment for the written advice in question. This modified approach to the disclosure of the election would achieve the same goals as the current disclosure requirements under the Final Regulations without creating the same turmoil and problems for the practitioners.

Even if the general election approach is not adopted, we believe the "prominently disclosed" requirement for the statement should be modified and clarified. In general, the requirement that the statement be located at the beginning of all written advice and in bolded larger type is neither necessary to achieve reasonable visibility nor to guarantee that the statement will be noted or understood by a reasonably attentive client. It is unnecessary to present the information in the extraordinary fashion required under Section 10.35(b)(8) in order to achieve the goals of providing clients with important information and then holding them accountable for knowing the information. So long as the statement is in typeface no smaller than that used for the general text and it is included anywhere immediately prior to or in the main text of the written advice, this should be sufficient to put the taxpayer on notice and preclude the taxpayer from asserting that the written advice covered by the statement can be used to avoid tax penalties. If Treasury and the IRS are concerned that these modifications would permit the statement to be buried in a lengthy document, this concern could be addressed by requiring the inclusion of the statement somewhere in the first two pages of the document (or, in the case of multiple statements, by clear reference in the first two pages of the document to the complete disclosure statement elsewhere in the document).

RECOMMENDATION 4 - MODIFY THE DEFINITION OF MARKETED OPINION

Relevant Circular 230 Provisions. As noted above, Section 10.35(b)(5) provides that written advice is considered 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 taxpayers, unless the practitioner includes a statement setting forth certain limitations on the use of the written advice.

In order to elect out of marketed opinion status, Section 10.35(b)(5)(ii) provides that written advice (other than advice concerning a listed transaction or a transaction concerning the principal purpose of avoidance or evasion of tax, as described in Section 10.35(b)(2)(i)(A) and Section

10.35(b)(2)(i)(B), respectively), 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

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

Problem The definition of a “marketed opinion” is overly broad and should be revised to exclude general information provided in a practitioner’s outlines prepared for other professionals and provided to clients for their information or knowledge, or for dissemination to others without attribution to the practitioner. The definition should also be revised to apply only to significant Federal tax issues. The breadth of the definition of a marketed opinion seemingly captures day to day and routine advice or communications by a tax practitioner. The following examples of situations that arguably involve marketed opinions highlight this issue.

Example 1. A lawyer is engaged by a bank or financial institution to prepare general informational materials regarding the creation of trusts, such as an irrevocable life insurance trust, for estate planning purposes. The informational materials will be distributed by the bank or financial institution to its clients and prospective clients. In this example, the practitioner knows that the bank or financial institution will use the informational materials in “promotion, marketing, or recommending” an arrangement. As a consequence, the informational materials must contain the three prominently disclosed written warnings. This is true even if the bank or financial institution uses the informational materials, without attribution to the lawyer, since the lawyer “knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner.”

Example 2. A lawyer writes an article or prepares an outline on a tax related topic that will be published in a tax journal or distributed at a seminar sponsored by the local bar association. The article is disseminated to an indeterminate number of people, one of whom may refer to it in recommending an arrangement to someone else. Therefore, such an article written by a practitioner and published in a commercial publication or distributed at a conference may be a covered opinion unless it contains the prominently disclosed “disclaimers” and “warnings” discussed above. The broad definition of “marketed opinion” has the effect of discouraging the publication of educational type articles or outlines by burdening the author with the requirements of a covered opinion.

Example 3. Lawyer X is a member of an e-mail based listserv. Members of the listserv regularly pose practice related questions and reply with suggested solutions. Lawyer A poses a question regarding tax planning opportunities involving the sale of an appreciated asset. Lawyer B replies by e-mail and suggests the use of a charitable remainder trust. All of the other members of the listserv receive a copy of the question by Lawyer A and a copy of the suggested solution by

Lawyer B. Lawyer X, who was not engaged in the dialogue, reads the question and suggested solution and concludes that a charitable remainder trust would be an appropriate solution for one of his clients. Lawyer X recommends a charitable remainder trust to his client. Once again, this type of exchange is caught within the definition of a marketed opinion, since it is a written communication that the practitioner (Lawyer B) has reason to know will be used by a person other than the practitioner in “promotion, marketing, or recommending” an arrangement. The broad definition of “marketed opinion” and the attendant required disclosures would have a chilling effect on these informal discussions among professionals.

Example 4. A planned giving officer of a public charity asks the charity’s lawyer to prepare a brochure the charity will provide to potential donors. The officer asks the lawyer to provide donor-friendly discussions of the income tax deductions for donations of various types of property, the differences between outright gifts, split-interest gifts and donor advised funds, and other charitable planning techniques. This brochure would arguably be considered a marketed opinion, as the charity will use it to promote planned gifts - some of which could be made with a significant tax avoidance purpose. The “advice” in the brochure, however, is not likely to be related to a significant Federal tax issue, and is likely to be very similar to some of the publications published by the IRS.

Suggested Solution. We recommend that the definition of a marketed opinion be revised to exclude general information provided in a practitioner’s outlines and articles prepared for other professionals and provided to clients for their information or knowledge, or for dissemination to others without attribution to the practitioner, and to be limited to advice concerning one or more significant Federal tax issues. The definition of a marketed opinion should also make clear that e-mail exchanges on listserv and other informal written discussions are specifically excluded.

RECOMMENDATION 5 - CLARIFY THE REQUIRED PROCEDURES BY PRACTITIONERS WITH OVERSIGHT RESPONSIBILITY

Relevant Circular 230 Provision. Under Section 10.36(a), each practitioner who either individually or as part of a group has principal authority and responsibility 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, associates and employees for purposes of complying with the requirements for covered opinions under Section 10.35 (“oversight practitioner”). Unless the effective date of Section 10.36(b) is delayed as recommended, a failure to meet the requirements of Section 10.36 could lead to fines, censure, suspension or disbarment of the oversight practitioner.

Problem It has always been prudent for the heads of tax practice groups to provide guidelines for the issuance of tax opinions and other formal tax advice. Opinion guidelines (for all firm practices) are recommended for risk management purposes, and are often mandated by malpractice insurers. Many firms have a “two partner” rule, which requires that two partners approve all formal opinions - often with one partner who is not involved in the transaction. Some firms require a third partner approval or a committee review when certain issues are raised or practice areas are involved. Some firms have “opinion banks” where all formal opinions are maintained. Those firms that have adopted these procedures have done so in limited

circumstances when the added administrative costs and fees, and time to deliver the opinions, are warranted.

Treasury in the Final Regulations has imposed requirements and it is unclear in some cases what steps are necessary to satisfy those requirements and in other cases those steps may be virtually impossible to meet. If the scope of the covered opinion requirements is not reduced, requiring the application of a formal opinion procedure to meet the requirements of Section 10.36 would result in a geometric increase in the costs and fees, possibly making some (even routine) advice impossible to deliver in a timely and cost-effective manner.

The various uncertainties under the Final Regulations are outlined above, such as the distinction between the “principal purpose” under Section 10.35(b)(2)(i)(B) and the “significant purpose” under Section 10.35(b)(2)(i)(C). Several IRS and Treasury officials have informally responded to practitioner’s concerns over the scope of Section 10.35 by recommending the use of a “common sense” approach based on what Treasury intended. If there are acknowledged problems with the substantive provisions of Section 10.35, then those problems will be highlighted when firms try to comply with Section 10.36. The types of questions that could arise include: (1) Could a firm’s “adequate procedure” include a “common sense” exception that would allow a practitioner to ignore a literal reading of Section 10.35 and (2) Would a procedure have to require the approval of another practitioner not involved in the transaction - even if the advice was only going to be provided in an informal email? It is doubtful that oversight practitioners will want to adopt a policy that leaves so much open to the interpretation of the individual practitioners, but it is unreasonable to expect the oversight practitioners to “fill-in” the gaps and uncertainties that are a direct result of the way Section 10.35 is currently written.

Practitioners have expressed concern about the lack of clarity as to what constitutes “reasonable steps” and “adequate procedures” under Section 10.36(a). For many firms and institutions, the ability of the oversight practitioner to monitor in a meaningful way the written documentation produced by each member, associate and employee is impossible and would be unreasonably burdensome. Furthermore, the clarification currently required for various provisions of the Final Regulations and the possible subjective nature for some of these issues means that even the most diligent oversight practitioner needs reasonable guidance as to what steps and procedures will be sufficient for purposes of Section 10.36. Imposing this burden and risk on the oversight partner without providing clear guidance on what is required compliance with Section 10.36(a) creates an unfair and unproductive risk for anyone serving as an oversight practitioner (especially if Section 10.36(a) is thought to apply beyond the oversight practitioner’s area of responsibility - such as to any practitioner who might provide, inadvertently or otherwise, tax advice). Providing the requested guidance should not hinder, but in fact help, achieve the goal of better compliance.

Suggested Solution. The requested guidance should outline reasonable and economically viable steps and procedures that, if implemented, will constitute a prima facie case of compliance with Section 10.36(a). The following are examples of reasonable and economically viable steps and procedures for inclusion in such guidance: (a) reasonable efforts to educate those likely to encounter “covered opinions” (possibly the entire firm, depending upon the practice areas), including by seminars, email, memoranda and other communications designed to inform practitioners of the existence of Section 10.35, the importance of complying with Section 10.35 and the risks to the practitioners, the firm and clients of noncompliance; (b) regular training

sessions for practitioners providing Federal tax advice and who are supervised by the oversight practitioner; (c) a firm policy regarding the issuance of covered opinions, possibly including prohibitions against issuing certain types of covered opinions (such as listed transactions), and/or restricting the issuance of other covered opinions (such as marketed opinions, without first consulting with the oversight practitioner); (d) firm policies on other relevant issues (e.g., procedure for giving a covered opinion, procedure for electing out of covered opinion treatment, identification of a firm representative to consult with regarding any questions).

RECOMMENDATION 6 - CREATE LIMITED EXCEPTION FOR NEGATIVE OR CERTAIN POST-TRANSACTION ADVICE

Relevant Circular 230 Provision. Section 10.35(b)(2)(i) defines a covered opinion as written advice “concerning one or more Federal tax issues arising from” three categories of transactions, as discussed above. (Emphasis added.)

Problem In Section 10.35(b)(2)(i), as currently written, the context in which the written advice is sought and the conclusion reached by the practitioner are irrelevant. As a result, the definition of a covered opinion can extend beyond what was or should have been intended.

Example 1. In 1999, a taxpayer participated in a “Son of Boss” transaction described in Notice 2000-44. The taxpayer has not settled the case and is trying to determine whether to litigate the case, and if so, in which venue. The taxpayer asks his tax litigation counsel for a memorandum outlining his options for litigation and the litigator’s opinion on the chances of success.

Example 2. A taxpayer receives a solicitation to invest in an investment for which the promoter promises deductions in multiples of the amount invested. The taxpayer emails her tax attorney to ask if the investment is a legitimate way for her to reduce taxes, saying “this seems a little too good to be true.” The attorney replies by email, “I have not thoroughly researched this investment, as it does seem too good to be true to me. I seriously doubt that this investment works as promised, especially due to the ‘at risk’ rules of Code § 465. I recommend that you run, not walk, away.”

The written advice in each of these examples concerns Federal tax issues. The memorandum regarding the litigation in the first example is a covered opinion because the tax issues arise from a listed transaction. The email in the second example could be a covered opinion because the tax could arguably arise from a potential transaction the principal purpose of which would be tax avoidance. The communications in each of these examples, however, *should not* be covered opinions from a policy standpoint.

Solutions. First, a taxpayer should be entitled to obtain certain post-transaction written advice related to any transaction, even a listed or other reportable transaction, without the need for the practitioner to comply with all of the covered opinion requirements. (We acknowledge, however, that some post-transaction advice can be relied upon for penalty protection, and therefore recommend that such advice remain subject to the Final Regulations, as modified.) Second, practitioners should be able to provide negative advice related to any transaction, even a

listed transaction. This type of advice should, in fact, be encouraged by the IRS - as it discourages participation in abusive transactions.⁷

We therefore recommend that Section 10.35(b)(2)(ii) be modified so that Section 10.35(b)(2)(ii)(B) be designated as Section 10.35(b)(2)(ii)(D), and that a new Section 10.35(b)(2)(ii)(B) and (C) be added, to read as follows:

(B) Written advice which the taxpayer cannot use to avoid or reduce penalties because the advice is rendered after the time the return is filed containing the item with respect to which the advice relates;

(C) Written advice in which the practitioner either advises against entering into a transaction or concludes that there is not at least a reasonable basis that all significant Federal tax issues would be resolved in the taxpayer's favor; or

RECOMMENDATION 7 - CLARIFY THAT PRACTITIONERS MAY DISCUSS OR GIVE ADVICE RELATED TO AUDIT RISK

Relevant Circular 230 Provisions. Neither the discussion of the requirements for providing a Covered Opinion in Section 10.35(c)(3)(iii) (quoted below) nor the discussion of the requirements for other written advice in Section 10.37(a) (quoted below) provide that a practitioner, in evaluating whether it is advisable for a taxpayer to engage in a transaction, cannot (in written advice) discuss: (i) the possibility that a tax return will be audited; (ii) the likely consequences of an audit or (iii) the prospects of settlement. These sections of the Final Regulations provide that the likelihood of an audit, the outcome of an audit or the prospects of settlement cannot be taken into account in evaluating a tax issue, *i.e.*, in determining whether the tax treatment is proper. In other words, the legal analysis on the merits cannot be based in whole or in part on any such possibility.

Section 10.35(c)(3)(iii) provides:

(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, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

Section 10.37(a) provides:

A practitioner must not give written advice (including electronic communications) concerning one or more Federal tax issues if the practitioner ... in evaluating a Federal tax issue, 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 resolved through settlement if raised.

Problem The distinction set forth above is illustrated by advice as to whether a taxpayer should make a gift directly to a child or instead make a gift to a GRAT. The practitioner is not

⁷ As stated above, the IRS has (at least informally) acknowledged this problem with Section 10.35.

precluded from advising the taxpayer that the amount of the gift depends upon a final determination of value, and if the gift is made to a GRAT, the client obtains protections from the gift tax consequences of a reevaluation on audit. The GRAT instrument can be drafted so that if the value is changed, the retained annuity is adjusted so that the taxable gift is not significantly increased. A client who has very hard to value assets, such as a closely-held business interest, and very little liquidity to deal with a gift tax audit or deficiency, may be well-advised to make the gift to a GRAT rather than outright. Clearly, it is appropriate for the practitioner to advise the client of the benefits of a GRAT in light of the risk of an audit adjustment. The consequences of the audit in the case of a GRAT had no effect on the practitioner's legal analysis or conclusion about how the taxable gift is properly calculated with a taxpayer makes a gift to a GRAT.

Further, in discussing with a client the regulations (Treas. Reg. § 301.6501(c)-1(f)) requirements concerning adequate disclosure on gift tax returns in order to achieve finality as to the value of a gift or whether a sale has a gift element, it is desirable to discuss what happens in an audit process. That discussion does not effect the practitioner's legal analysis or conclusion about whether a transaction is a gift or a sale. It simply allows the practitioner better to serve the client by informing the client about the requirements and potential results of filing a gift tax return. (Finally, although this issue is covered in part by Recommendation 6, written advice provided to a taxpayer involved in an audit or controversy with the IRS should clearly be allowed to address whether an issue might be raised on audit or resolved through settlement if raised.)

There is concern that confusion may arise because the preamble to the Final Regulations provides:

Under § 10.37 a practitioner must not give written advice if the practitioner ...

(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.

Suggested Solution. If and when amended regulations are issued, we recommend that clause (4) of the preamble be modified to read as follows to be consistent with Sections 10.35(c)(3)(iii) and 10.37(a):

(4) in evaluating the merits of a Federal tax issue, 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.