

Proposed Revisions to Circular 230
ABA Section of Taxation
Recommendation

April 24, 2002

The American Bar Association Section of Taxation (the "Section") recommends that the Treasury Department revise section 10.35 of the proposed Circular 230 regulations, dealing with certain opinions requiring enhanced due diligence. The revised section 10.35 would combine the subject matter of two sections in the proposed regulations: section 10.33, concerning opinions used by a third party to market a tax shelter, and section 10.35, concerning opinions concluding that the proposed treatment of a tax shelter is more likely than not the proper treatment. If the recommendation is adopted, sections 10.33 and 10.35 of the proposed regulations would be withdrawn, and the revised section 10.35 would replace them. The recommendation and proposed regulatory language are submitted on behalf of the Section of Taxation. Neither the recommendation nor the regulatory language have been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

Following are (1) an explanation of the recommendation (the "Recommendation") and (2) proposed regulatory language for a revised section 10.35 to implement the Recommendation.

The Section has previously submitted comments with respect to the proposed regulations. After significant discussion, the Section submits the following as a substitute for its prior comments.

On March 20, 2002, the Treasury Department released several proposals to combat abusive tax avoidance transactions including, *inter alia*, a new definition for "reportable transactions" and new rules intended to streamline the standards for registration, disclosure, and maintenance of lists, of such transactions. In light of these proposals, we considered whether the transactions subject to heightened due diligence under Circular 230 should be the same as the transactions proposed by Treasury as reportable transactions. In a broad sense, the proposed rules for reportable transactions and the Circular 230 standards are related, in that both are designed to strengthen the integrity of the tax system. As a result, some overlap between these two sets of regulatory guidance may be appropriate (and in those instances consistent definitional or other criteria should be used). Nevertheless, we think that the ethical focus of the Circular 230 rules differs substantially from the more mechanical disclosure focus of the "reportable transaction" rules. Accordingly, we have concluded that imposing Circular 230 standards solely by reference to "reportable transactions" would not be appropriate.

Circular 230, like other professional standards, recognizes that the practitioner plays a broader role in the tax system than merely that of a client advocate. The practitioner has a professional responsibility to provide advice that is commensurate with the complexity and risk involved in transactions, in some circumstances even if the client would not necessarily wish to be so advised. The tests that we have proposed are intended to identify situations in which either the potential for tax abuse, or the nature of the client relationship, make it appropriate to require the practitioner either to fully advise a client concerning the tax consequences of a transaction, or

to decline to advise the client at all. In contrast, disclosure rules are intended to provide the IRS with information about transactions that the IRS believes it should review, and to assure that the prospect of disclosure and review are part of the taxpayer's decisionmaking process.

As a result, the factors that we propose do not necessarily coincide with those applicable in determining whether registration, list maintenance, and disclosure is required. For example, in the case in which a professional opinion is given to a party other than the taxpayer, and is used by the recipient to market a tax shelter to the taxpayer (so-called "third-party marketing"), the practitioner is not subject to the constraints of a direct professional relationship with the taxpayer, and professional regulation is therefore considered appropriate. This rationale has been reflected in Circular 230 since the initial tax shelter provisions in 1984 and remains sound, without regard to the area of tax law that is involved. In addition, we have suggested a factor concerning arrangements for a substantial fee that is not reasonably related to reasonable hourly rates. As in the case of third party marketing, such arrangements present pressures to downplay issues and analysis which may call into question the desired tax result. Accordingly, such arrangements present an appropriate case for regulation of the thoroughness and diligence associated with the opinion, without regard to the kind of transaction involved. There will be other cases in which the bright-line tests for "reportable transactions" will apply, but for which there should not be opinion regulation, because the marketplace will assure appropriate levels of thoroughness and diligence. For these reasons, we believe it is appropriate for Circular 230 transactions and reportable transactions to diverge in some respects.

I. Explanation of the Recommendation

A. Background

Section 330 of title 31 of the United States Code authorizes the Secretary of the Treasury to regulate the practice of taxpayers' representatives before the Treasury Department. The existing regulations (published in "Circular 230" and appearing at 31 CFR Part 10) have since 1984 included provisions on opinions used to market a tax shelter. In February, 2000, the Treasury Department announced a number of measures to deal with the perceived increased use of abusive tax shelters, particularly by corporate taxpayers. These measures included a decision to broaden the provisions on tax shelter opinions in Circular 230 as part of a general revision. The Treasury requested comments on the subject in advance of the proposed regulations, and subsequently issued proposed regulations on January 12, 2001, making revisions to Circular 230, including the tax shelter opinion provisions.

The January 12 proposed regulations provided generally that a tax shelter opinion would have to address all material tax issues in the transaction if either (1) the opinion reached a conclusion that it was more likely than not that the proposed treatment of the tax shelter was the proper treatment, or (2) the practitioner knew that a third party promoter would use the opinion in marketing the tax shelter to taxpayers. Tax shelters were defined by reference to section 6662 as transactions with a "significant purpose" of avoidance of Federal income tax¹, with exceptions

¹ The proposed regulations, and the Recommendation, relate only to Federal income tax. Any extension of Circular 230 to opinions involving other taxes (e.g., estate and gift or employment taxes) is beyond the scope of this Recommendation and would require careful consideration.

for municipal bond issues and qualified retirement plans. The preamble to the January 12 proposed regulations requested comments on other transactions that should be excepted.

In the last few years, the term “tax shelter” has conjured up a perception of an abusive or extraordinarily aggressive transaction that is contrary to Congressional intent and well-established judicial doctrines. However, the legislative definition, used to target transactions that are subject to heavy penalties or require disclosure and/or registration, is so broad that it brings ordinary and legitimate transactions within its scope. Specifically, section 6662 defines as a “tax shelter” any transaction that has “a significant purpose of tax avoidance.” We believe this definition is too broad to be used in delineating the transactions that should be subject to the heightened due diligence requirements of Circular 230 because of their potentially abusive nature. With this in mind, the Section recommends that a more neutral phrase be used to describe the transactions that would trigger such procedures. Under our formulation, a transaction that meets one or more of the enumerated tests would be a “section 10.35 transaction,” subject to the recommended due diligence procedures described in that section.

Under the Recommendation, the requirements for opinions with respect to section 10.35 transactions would be set forth exclusively in a revised section 10.35 of the regulations. The revised section 10.35 would replace section 10.33 of the January 12 proposed regulations, dealing with tax shelter opinions used in marketing, and section 10.35 of the January 12 proposed regulations, dealing with “more likely than not” tax shelter opinions.

B. Summary

Under the Recommendation, a section 10.35 transaction is a transaction that satisfies any one of six alternative tests. The six alternative tests are:

- (1) The transaction is a “listed transaction” described in Reg. § 1.6011-4T(b)(2);
- (2) The principal purpose of the transaction is the avoidance or evasion of Federal income tax;
- (3) The practitioner has reason to believe or actual knowledge that the taxpayer has participated in the transaction under conditions of confidentiality;
- (4) The practitioner has reason to believe or actual knowledge that the taxpayer has obtained contractual protection (other than a possible reduction in the practitioner’s fee) against the possibility that the intended tax benefits will not be sustained;
- (5) The practitioner receives a fee with respect to a transaction (or a series of related transactions for the taxpayer and related parties) which satisfies two requirements: (x) the fee from a corporation (and related parties) is in excess of \$100,000 or the fee from an individual (and related parties) is in excess of \$50,000, and (y) in either case, the fee arrangement is an indicative fee arrangement; i.e., an arrangement where the practitioner’s

fee is not reasonably related to the amount that the practitioner would receive if the practitioner received only a reasonable hourly rate for the services rendered; and

- (6) The practitioner has reason to believe or actual knowledge that the opinion will be used by a party other than the practitioner or the practitioner's firm to market or promote the transaction to taxpayers

The second through the sixth tests are subject to an exception for transactions clearly consistent with the purposes of the applicable provisions of the Internal Revenue Code and transactions submitted for review by the Service prior to being reported on the taxpayer's return.

An opinion with respect to a section 10.35 transaction as thus defined must address all issues as to which the Service would have a realistic possibility of a successful denial of claimed tax benefits.

The Section recognizes that in some situations the purpose of an opinion on a transaction is primarily to assist a taxpayer to establish that it satisfied the reasonable belief, reasonable cause, or good faith criteria under the penalty provisions of sections 6662 and 6664 ("penalty protection"). Arguably, the goals of Circular 230 concerning such opinions could be achieved by making Circular 230 applicable to, and only to, opinions offered for purposes of penalty protection. Notwithstanding this, however, the Recommendation makes Circular 230 applicable to any opinion concerning a section 10.35 transaction, as defined, regardless of whether the opinion is intended to create penalty protection. This is because, in our view, (i) advice on potentially abusive transactions that do not meet the standards of Circular 230 undermines the integrity of the tax system, and (ii) removing penalty protection from opinions that do not conform with the requirements of Circular 230 places the onus on the taxpayer, while Circular 230 is intended to regulate the conduct of practitioners. We believe that the attractiveness of abusive transactions will be reduced if practitioners are required to disclose all relevant issues and risks to taxpayers. This is appropriate in our current environment despite the fact that some transactions that meet the heightened due diligence procedures contained in section 10.35 are substantively sound under today's rules.

C. Definition of 10.35 transaction

The definition of a "section 10.35 transaction" in the proposed regulatory language is intended to identify transactions in which there is a reason to require full discussion by the practitioner of all material tax issues relating to the transaction.

The first test under this definition relates to transactions that have been identified by the Internal Revenue Service as "listed transactions" under Treas. Reg. § 1.6011-4T(b)(2). This test is not based on the purpose of the transaction; all listed transactions would be treated as section 10.35 transactions for purposes of Circular 230.

The second test covers transactions with "the principal purpose of tax avoidance or evasion." The Section believes that it is appropriate to regulate the conduct of practitioners in rendering written advice with respect to transactions that have as their principal purpose the avoidance or evasion of tax because of the significant possibility that the intended tax

consequences of such transactions could be successfully challenged by the Internal Revenue Service. This differs from the proposed regulations issued by the Treasury Department on January 12, 2001, which would use the section 6662 definition of a tax shelter: a transaction having a “significant purpose” of tax avoidance or evasion instead of the “principal purpose.” The Recommendation uses this narrower definition for Circular 230 because, we believe, the regulation of practitioners under Circular 230 is supplemental to a broad body of existing professional regulation and therefore should be limited in its application. The presence of “the principal purpose of tax avoidance or evasion” should be determined using the pre-1997 regulations under section 6662 that address this question.

The Recommendation’s other tests for identification of a section 10.35 transaction look to the presence of one or more characteristics that have been associated with potentially abusive transactions. The third and fourth tests pertain to written advice provided (i) under conditions of confidentiality, or (ii) in connection with a transaction in which the taxpayer has obtained or been provided with contractual protection (other than a reduction in the practitioner’s fee) against the possibility that the intended tax benefits will not be sustained.

The fifth characteristic that would trigger the section 10.35 due diligence standards is where the practitioner enters into an “indicative fee arrangement” with the taxpayer with respect to the transaction. These arrangements are the type often present in promoted tax strategies that promise substantial tax savings. The fee received by the practitioner from a taxpayer and its related parties will be treated as an indicative fee arrangement only if two requirements are met: (1) the fee from a taxpayer and related parties with respect to the transaction or a series of related transactions exceeds \$100,000 in the case of a corporation or \$50,000 in the case of an individual; and (2) the practitioner’s fee is not reasonably related to the amount that the practitioner would receive if the practitioner received only a reasonable hourly rate for the services rendered. This test is intended to identify fee arrangements relating to significant transactions in which the practitioner has a material entrepreneurial interest in the claimed tax benefit of the transaction. For this reason, an opinion for which a practitioner enters into an indicative fee arrangement should meet the enhanced due diligence standards of Circular 230, even though such fee arrangements may be found in transactions that are not abusive.

In making this Recommendation, the Section is aware that some practitioners do not charge by the hour for their services and that some taxpayers insist on flat-fee arrangements. In addition, the Section understands that practitioners may agree to reduce or waive a fee if a transaction does not occur. Taxpayers often request such fee arrangements. To reflect these types of arrangements, the Recommendation provides that a fee arrangement providing for a contingent fee that is permissible under section 10.27 is not an indicative fee arrangement, because section 10.27 permits certain fees based on other than reasonable hourly rates. Any other contingent fee arrangement could be indicative of a transaction that would require compliance with the prescribed section 10.35 due diligence standards unless the fee were not greater than the amount that would be received if the taxpayer charged on a reasonable hourly basis.

Likewise, the Recommendation provides that a fee arrangement is not an indicative fee arrangement merely because the fee is in excess of normal hourly rates by virtue of a reasonable premium for reasons such as the difficulty or novel nature of a transaction, the fact that the fee is contingent on the closing of the transaction, or other special circumstances.

Similarly, a fee arrangement is not an indicative fee arrangement merely because the fee is a fixed amount if the fixed amount is not greater than a reasonable estimate of the maximum hourly charges that could accrue on the matter, including a reasonable premium. In determining reasonable hourly rates, reference may be made to the highest hourly rates that are charged by similarly-situated practitioners for comparable matters. The Recommendation includes examples of premium and contingent fees that are not indicative fee arrangements under the standards of the Recommendation as well other fee arrangements that are indicative fee arrangements.

For purposes of these rules, the practitioner must take into account the entire fee paid to the practitioner and the practitioner's firm for a transaction or a series of related transactions by the taxpayer and its related parties, regardless of whether the fee is attributable in part to services that are not related to tax matters; related parties are defined by reference to sections 267(b) and 707(b). Thus, the Recommendation does not permit or require the allocation of fees between tax services and non-tax services, other than audit fees which are specifically excluded. Such an allocation could be unworkable in practice and could allow practitioners to avoid the requirements of Circular 230 by artificially splitting their fees.

The Section recommends use of a reasonable dollar threshold to eliminate relatively small transactions that should not have to bear the increased expense of an opinion that meets the standards of Circular 230. The fee thresholds proposed by the Section for corporations and individuals are lower than the standard for reportable transactions under the Treasury's recent recommendations concerning registration and list maintenance under section 6111 and 6112, respectively, because those thresholds appear to contemplate the aggregation of fees charged to unrelated taxpayers. Furthermore, a lower fee threshold appears to be appropriate for determining whether heightened due diligence should apply because of the different purposes underlying the various provisions. Nevertheless, coordination of the applicable fee levels ultimately may be appropriate when the regulations under section 6111 and 6112 are finalized. The exception for fees determined on the basis of a reasonable hourly rate is expected to exclude tax planning advice provided by practitioners in connection with routine transactions. At the same time, as illustrated in the examples, these rules are intended to include within the definition of an indicative fee arrangement those transactions in which the practitioner has an entrepreneurial interest in the transaction.

The sixth characteristic that would trigger the section 10.35 due diligence standard relates to use of opinions in "third party" marketing; *i.e.*, the opinion is provided by the practitioner for use by a party other than the practitioner (or the practitioner's firm) in marketing to taxpayers. This test is based upon the current rules in section 10.33 of Circular 230. We concur with the Treasury's conclusion that third-party marketing could be perceived as detrimental to the tax system, so that it is appropriate to apply the Circular 230 requirements to all opinions used in third-party marketing.

D. Exceptions

A transaction that is clearly consistent with the purposes of the Internal Revenue Code will not be considered as having the principal purpose of tax avoidance, and the Recommendation therefore excludes these transactions from the second through the sixth tests

(but not the first test). The Recommendation recognizes that a transaction that is clearly consistent with the purposes of the Code may be part of a larger transaction that is not clearly consistent with the purposes of the Code. In that event, the Recommendation authorizes the Service to require the practitioner to comply with the section 10.35 due diligence standards for the larger transaction if it satisfies any of the described tests.

The requirement that an excluded transaction be “clearly consistent” with the purposes of the Code differs from the existing section 6662 regulations, which do not include the term “clearly.” This difference imposes a more stringent standard than the existing section 6662 regulations if a transaction is to be excluded from the section 10.35 due diligence standards on this basis.

An exception from the second through the sixth tests is also provided for any matters for which there will be substantive review by the Internal Revenue Service (e.g., advice in connection with a ruling request, pre-filing agreement, or an accounting method change). Such transactions are not likely to be indicative of abuse, because the transaction will be reviewed by the Internal Revenue Service.

E. Opinions

Under the Recommendation, a section 10.35 opinion must address all income tax issues as to which the Service would have a realistic possibility of a successful denial of claimed tax benefits. The realistic possibility standard is the same as the standard under the existing section 10.34 regulations, except that in this context the party as to which the standard is applicable is the Service rather than the taxpayer. The opinion must state that the practitioner has considered the possible application to the facts of all reasonably relevant judicial doctrines, including the step transaction, business purpose, economic substance, substance over form, and sham transaction doctrines, as well as reasonably relevant statutory and regulatory anti-abuse rules.

Under the Recommendation, a section 10.35 opinion that does not reach a favorable overall conclusion (i.e., a conclusion that the Federal income tax treatment of the item is more likely than not the correct treatment) must disclose that it does not offer grounds for reasonable belief, reasonable cause, or good faith under the tax shelter provisions of section 6662 and 6664. This requirement is intended to foster full disclosure of tax risks in transactions within the scope of Circular 230.

The Recommendation defines opinions as written advice concerning the Federal income tax aspects of a transaction. In the development of a transaction, a practitioner may frequently give written advice on a portion of the transaction in a relatively informal manner, for example, by a memorandum or an electronic mail message (e-mail). The Recommendation assumes that in administering Circular 230, the Director of Practice would accept the overall course of conduct between the parties and disregard any preliminary communications if they are later subsumed in written advice that meets the standards of Circular 230.

A similar issue can arise with respect to written advice in the development of a transaction as to matters on which a private ruling is later requested from the Service. In this

circumstance, the initial written advice should be regarded as subsumed in the ruling request and, therefore, would not be subject to section 10.35.

Standards are provided under which a practitioner may comply with Circular 230 in giving an opinion that relies on the opinion of another practitioner as to a portion of a transaction. There is no specific rule directed at the practitioner who gives the opinion that is relied upon (the “underlying opinion”). If the underlying opinion is a section 10.35 opinion based on the portion of the transaction to which it relates, it should comply with Circular 230 on the same basis as other section 10.35 opinions.

Opinions include a discussion of tax matters in offering materials prepared or reviewed by or at the direction of a practitioner, if the name of the practitioner or the practitioner’s firm is referred to in the offering materials or in connection with sales promotion efforts that use the offering materials. In this respect, the Recommendation differs from the January 12 proposed regulations, which would include any offering materials prepared by the practitioner, regardless of whether the practitioner’s name was used, but not materials which the practitioner merely reviewed without the use of the practitioner’s name. The Recommendation rejects the distinction between preparation of materials and review of materials as being too difficult to administer in practice and, by the same token, too easy to manipulate by having the practitioner refrain in all cases from “preparing” the materials.

The definition of an opinion includes advice to or for the use of a taxpayer from a practitioner who is an officer, partner or employee of the taxpayer. No reason is perceived why an opinion in this category should be treated differently from any other practitioner opinion.

F. Relationship With Other Sections of Circular 230

Written advice that is provided as a basis for a tax return reporting position, but is excepted from the requirements of section 10.35 because the transaction is clearly consistent with the purposes of the Code, must nonetheless comply with all of the standards of practitioner conduct, including section 10.34.

The Recommendation defines "practitioner" by reference to the general definition in section 10.2(f), under which it is irrelevant whether the practitioner has filed a declaration as part of a power of attorney or has enrolled under Circular 230. A similar provision is appropriate under section 10.34 relating to return preparation, and if the Recommendation is adopted, it may be preferable to address the matter in section 10.2 rather than separately in sections 10.34 and 10.35.

G. Effective Date

Regardless of the effective date of other provisions of the proposed regulations, the provisions relating to section 10.35 opinions should not be effective for opinions issued prior to 180 days after the adoption of final regulations. A substantial period may be necessary both for analysis and understanding of the regulations and for implementation of operating procedures within a practitioner’s firm.

H. Post-adoption Review; Temporary Regulations

Many of the concepts in the Recommendation are novel and untried. If the Recommendation is adopted, the Treasury should monitor the application and effects of the Recommendation in order to be able to implement changes or improvements as deemed appropriate. Use of Temporary Regulations should be considered for this reason.

II. Proposed Amendment to the Circular 230 Regulations

To implement the Recommendation, the Treasury Department should withdraw 31 CFR section 10.33 of the existing regulations and the proposed regulations and should adopt a revised section 10.35 in the following form:

Section 10.35 Opinions.

(a) Overview — Section 10.35 provides special standards and requirements for the preparation and content of opinions concerning the Federal income tax aspects of a section 10.35 transaction (as described in paragraph (b)). However, such requirements do not apply to any opinion with respect to certain transactions that are designed to result in tax benefits that are clearly consistent with the purposes of applicable Internal Revenue Code provisions. Section 10.35 does not affect the practitioner’s obligation to comply with the standards of conduct prescribed by section 10.34 with respect to opinions provided as a basis for a tax return reporting position. The standards and requirements for opinions concerning section 10.35 transactions are set forth in paragraph (c). Paragraph (d) deals with competence to provide opinions and reliance on opinions of others. Paragraph (e) deals with the effect of an opinion meeting the requirements of section 10.35. Paragraph (f) authorizes the Director of Practice to establish an Advisory Committee with respect to alleged violations of section 10.35.

(b) Definition of a section 10.35 transaction. A transaction is a section 10.35 transaction if it is described in any of the following paragraphs (1) through (6) and, in the case of transactions described in paragraphs (2) - (6), is not described in paragraph (7).

(1) Listed transactions. A transaction is described in this paragraph (1) if it is the same as or substantially similar to a transaction that the Internal Revenue Service has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a “listed transaction” within the meaning of Treas. Reg. § 1.6011-4T(b)(2).

(2) Principal purpose of tax avoidance or evasion. A transaction is described in this paragraph (2) if, based on all pertinent facts and circumstances, the principal purpose of the transaction is to avoid or evade Federal income tax. The principal purpose means that purpose

exceeds any other purpose. The existence of economic substance does not of itself establish that a transaction does not have the principal purpose of tax avoidance. See Reg. § 1.6662-4(g)(2)(i) and (ii).

(3) Confidentiality conditions. A transaction is described in this paragraph (3) if the practitioner has reason to believe or actual knowledge that the taxpayer has participated in the transaction under conditions of confidentiality, provided that a statement in a tax opinion that such opinion may not be relied upon by third parties shall not constitute a condition of confidentiality.

(4) Contractual protection. A transaction is described in this paragraph (4) if the practitioner has reason to believe or actual knowledge that the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained, including, but not limited to, rescission rights, potential payments that are contingent on the taxpayer's realization of tax benefits from the transaction, insurance protection with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement (but excluding (a) a reduction in the practitioner's fees or (b) a customary indemnity provided by a principal to the transaction that did not participate in the promotion of the transaction to the taxpayer).

(5) Indicative fee arrangement. A transaction is described in this paragraph (5) if the practitioner enters into a fee arrangement concerning the transaction that is an indicative fee arrangement. A fee arrangement is an indicative fee arrangement only if (a) the fee for the transaction or a series of related transaction for the taxpayer and related persons exceeds \$100,000 in the case of a corporation or \$50,000 in the case of an individual, and (b) the fee is

not reasonably related to the amount that would be received by the practitioner based on a reasonable hourly rates for professional services. In determining whether a fee arrangement is an indicative fee arrangement, the following rules shall apply:

(A) A fee may be considered reasonably related to the amount that would be received by the practitioner based on a reasonable hourly rates for professional services notwithstanding that (I) the fee includes a premium on account of the difficulty or novelty of the transaction, (II) the fee is contingent on the completion or closing of a transaction or the contingency is permitted under section 10.27, or (III) the fee is a fixed amount that is payable in all events, provided that the fixed amount is not greater than a reasonable estimate of the maximum amount that would be charged based upon a reasonable hourly rate, including a premium for novelty, difficulty, or contingency of closing.

(B) For purposes of applying the dollar-amount thresholds, the practitioner must aggregate the fees charged in connection with a transaction or a series of related transactions for the taxpayer and related persons. A practitioner must take into account the entire fee paid to a practitioner and the practitioner's firm for a transaction or a series of related transactions (other than audit fees), regardless of whether the fee is attributable in part to services that are not related to tax matters.

(C) In determining reasonable hourly rates for services rendered, reference may be made to the highest hourly rates that are charged by similarly-situated practitioners for comparable matters.

(D) A fee that is less than the amount that would be received based on reasonable hourly rates is not an indicative fee arrangement.

(6) Third-party marketing. A transaction is described in this paragraph (6) if the practitioner has reason to believe or actual knowledge that the practitioner's opinion will be used or referred to by a person other than the practitioner (or any person who is a member of, associated with, or employed by the practitioner's firm or company) in promoting or marketing the transaction to one or more taxpayers, whether such promotional, marketing, or similar activities are conducted privately or publicly.

(7) Exceptions and Definitions. The following exceptions and definitions shall apply for purposes of this section 10.35:

(i) Transactions clearly consistent with Code. A transaction is described in this paragraph (7), and therefore is not a section 10.35 transaction, notwithstanding that it is described in one or more of paragraphs (2) through (6), if the transaction is structured and effectuated with the objective of claiming exclusions or deferrals of income, tax credits, accelerated deductions or other tax benefits that are clearly consistent with the purposes of applicable provisions of the Internal Revenue Code (as evidenced by relevant statutory language, legislative history, underlying final or temporary Treasury regulations or other published administrative guidance), but only if the underlying facts of the transaction are clearly consistent with the requirements of such provisions. The fact that a transaction is clearly consistent with the purposes of the Internal Revenue Code does not necessarily mean that a larger transaction of which it is part is consistent with such purposes. If an opinion excepted from the application of section 10.35 by reason of this paragraph (b)(7) is provided by the practitioner to a taxpayer as a basis for a tax return reporting position, the practitioner must nevertheless satisfy, with respect to such opinion, all of the standards of conduct prescribed by section 10.34.

(ii) Transactions subject to IRS Review. A transaction described in paragraphs (2) through (6) that will be subject to review by the Internal Revenue Service prior to implementation by the taxpayer, such as a proposed transaction that is the subject of a private ruling issued by the Service or an accounting method change that is granted by the Service, is not a section 10.35 transaction.

(iii) Opinion. For purposes of section 10.35, an opinion is written advice by a practitioner or the practitioner's firm concerning the Federal income tax aspects of a transaction. An opinion includes the Federal tax matters or tax risks portion of offering materials prepared or reviewed by or at the direction of a practitioner, if the name of the practitioner or the practitioner's firm is referred to in the offering materials or in connection with sales promotion efforts that use the offering materials. Advice to or for the use of a taxpayer from a practitioner who is an officer or employee of the taxpayer may be an opinion for purposes of this section if it otherwise falls within the definition of an opinion.

(iv) Transaction. For purposes of section 10.35, a transaction may include (A) the use of any entity, plan, or arrangement or (B) a series of transactions carried out pursuant to a common plan.

(v) Practitioner. For purposes of section 10.35, a practitioner includes any individual described in section 10.2(f), regardless of whether the individual has in fact filed a declaration or enrolled pursuant to this part.

(vi) Related Person. For purposes of section 10.35, two or more persons are related if they are in a relationship described in section 267(b) or section 707(b).

(8) Examples. The following examples illustrate the definition of a section 10.35 transaction. Each example assumes that the transaction is not described in the exception of paragraph (b)(7) for transactions that are clearly consistent with the Internal Revenue Code.

Example 1. A practitioner writes a memorandum that evaluates whether a hypothetical taxpayer who enters into a described transaction can offset a pre-existing capital gain against certain losses arising from the transaction. The practitioner concludes that, while the principal purpose for entering into the transaction is the avoidance or evasion of Federal income tax within the meaning of paragraph (b)(2), there is a realistic possibility (or higher level of confidence) that the tax loss arising from the transaction is the proper treatment. The practitioner plans to provide this memorandum directly to one or more existing or prospective clients who have capital gains. The transaction is a section 10.35 transaction, and the memorandum is an opinion subject to section 10.35. The memorandum would still be subject to section 10.35 if it were instead provided in response to a specific client request for tax advice regarding such a transaction.

Example 2. A practitioner prepares a memorandum describing a tax planning strategy for a person (other than a member of the practitioner's firm) who will use or refer to the memorandum (or to the practitioner or the practitioner's firm) in promoting or marketing the strategy. The memorandum is subject to section 10.35 because it is described in paragraph (b)(6).

Example 3. A practitioner prepares a memorandum for a client explaining a tax planning strategy, and the client has agreed not to disclose the memorandum or the tax planning strategy to any other person. Avoidance of Federal income tax is not the principal purpose of the

transaction. Because the transaction is recommended under conditions of confidentiality, the memorandum is subject to section 10.35.

Example 4. A corporate taxpayer engages a firm to represent it in a transaction, including delivering opinions on tax matters as well as other matters. Payment of the firm's fee will be contingent on the transaction closing. The fee is to be based on the firm's hourly rates for professional services of this nature, with a reasonable premium in consideration of certain unusual and difficult aspects of the work in the transaction and the risk that the transaction will not close. The fee, if the transaction closes, will be in excess of \$100,000. The fee arrangement is not an indicative fee arrangement. The fee to be charged is reasonably related to the value of the time spent by the firm on the matter as measured by the firm's hourly rates, taking into account the work to be accomplished and the fact that no payment will be received if the transaction does not close.

Example 5. The transaction described in the preceding example does not close, and the firm does not receive any fee. Later in the same year, the firm accepts an engagement from a second, unrelated taxpayer for a similar transaction. The firm and the second taxpayer agree on a fee of \$350,000 that will be payable if, and only if, the transaction closes, regardless of the number of hours that are necessary to complete the engagement. The firm estimates at the outset of the transaction that a fee based on regular hourly rates for services of this type, including the work on the failed first transaction as well the work to complete the second transaction, would be in the range of \$250,000 to \$300,000 and that the increment to \$350,000 is fair compensation for the unusual and difficult aspects of the work in the transaction and the risk that the transaction will not close. The fee arrangement is not an indicative fee arrangement

because the total fee to be received by the firm is related to a reasonable hourly rate, taking into account the nature of the services provided and the possibility that the transaction will not close.

Example 6. A firm undertakes an engagement to deliver a tax opinion to a corporate client on a transaction for a fee of \$1 million regardless of the number of hours that are necessary to complete the engagement; the fee will be paid only if the transaction closes. The firm estimates that a fee based on reasonable hourly rates for services of this type would be in the range of \$100,000 to \$200,000. This is an indicative fee arrangement because the fees to be charged are not related to a reasonable hourly rate for the services rendered, even after taking into account the possibility that the transaction may not close.

Example 7. A firm accepts an engagement to prepare a memorandum of authorities concerning a proposed corporate transaction; the fee to be paid is \$350,000, which fee is based on a reasonable hourly rate for the services to be rendered. After the first memorandum is completed and delivered, the firm then accepts during the next year an engagement from a second, unrelated taxpayer to deliver a tax opinion on a similar transaction for a fee of \$350,000, but the firm knows at the time that it accepts this engagement that it will not be required to perform significant additional services to provide the second memorandum because of its ability and intent to rely upon the first memorandum. The fee charged in connection with the preparation of the second memorandum is an indicative fee arrangement because the fee exceeds \$100,000 and is not based on reasonable hourly rates. A fee based on reasonable hourly rates would have been significantly less than \$350,000 because of the savings from use of the first memorandum.

Example 8. The facts are the same as in the preceding example except that the firm's fee charged for each memorandum is only \$80,000. Because the fees charged for the second transaction is below \$100,000 in the case of a corporate taxpayer, the fee is not an indicative fee arrangement. Fees charged to unrelated taxpayers are not aggregated for purposes of determining whether paragraph (b)(5) applies. However, if the two corporations were related, then an indicative fee arrangement would result.

Example 9. A practitioner agrees to obtain a private ruling for a client in exchange for a flat fee of \$1 million, payable only if the ruling is obtained. The fee that would be charged for the practitioner's services, based on a reasonable hourly rate and taking into account the novelty and difficulty of the work and the contingencies involved, would be less than \$500,000. Although the fee arrangement is not based on a reasonable hourly rate, the fee is not an indicative fee arrangement because the transaction will be subject to review by the Internal Revenue Service as part of the ruling request.

Example 10. A practitioner provides opinions to corporations in connection with the sale of partnership interests intended to create a right to low-income housing credits under section 42. The proposed transactions are clearly consistent with the purposes of section 42. The practitioner charges \$125,000 per opinion, which fee is not based on a reasonable hourly rate for the services rendered in providing such opinions. Although the fees received by the practitioner for providing opinions exceed \$100,000, and although such fees are not based on a reasonable hourly rate, Section 10.35 does not apply because the transactions are clearly consistent with the purposes of section 42.

Example 11. A practitioner is requested by an individual client to provide a short memorandum concerning an issue that the practitioner previously examined for another client. The practitioner anticipates that it will only take the practitioner a few hours to prepare the memorandum, but the fee charged to the client will be a flat fee of \$40,000. Although the fee received by the practitioner is not based on a reasonable hourly rate, because the total fees related to the transaction and substantially similar or related transactions for the taxpayer is less than \$50,000, the fee arrangement is not an indicative fee arrangement.

(c) Compliance requirements. A practitioner who provides an opinion with respect to a section 10.35 transaction must comply with each of the following requirements with respect to the opinion.

(1) Factual matters. The practitioner must make inquiry as to all relevant facts, be satisfied that the opinion takes account of all relevant facts, and be satisfied that the material facts (including factual assumptions and representations) are accurately and completely described in the opinion and, where appropriate, in any related offering materials or sales promotion materials.

(i) The opinion must not be based, directly or indirectly, on any unreasonable factual assumptions (including assumptions as to future events). Unreasonable factual assumptions include –

(A) A factual assumption that the practitioner knows or has reason to believe is incorrect, incomplete, inconsistent with an important fact or another factual assumption, or implausible in any material respect; or

(B) A factual assumption regarding a fact or facts that the practitioner could reasonably request to be provided or to be represented.

(C) A factual assumption that the transaction has a sufficient business reason, adequate potential profit apart from tax benefits, or is otherwise not susceptible to being disregarded as a sham, or an assumption as to a material valuation issue.

(ii) A practitioner may, if it would be reasonable based on all the facts and circumstances, rely on factual representations, statements, findings, or agreements of the taxpayer or other persons (factual representations) (including representations describing the specific business reasons for the transaction, the potential profitability of the transaction apart from tax benefits, or a valuation prepared by an independent party). Factors relevant to whether such factual representations are reasonable include, but are not limited to, whether the person making the factual representations is knowledgeable as to the facts being represented and would be the appropriate person to make such factual representations if the issue was being litigated. A practitioner does not need to conduct an audit or independent verification of a factual representation, but the practitioner must exercise due diligence and may not rely on factual representations if the practitioner knows or has reason to believe, based on his or her background and knowledge, that the relevant information is, or otherwise appears to be, unreasonable, incorrect, incomplete, inconsistent with a material fact or another factual representation, or implausible in any material respect. For example, a representation is incomplete if it states that there are business reasons for the transaction without describing those reasons, or if it states that a transaction is potentially profitable apart from tax benefits without providing adequate factual support. In addition, a valuation is inconsistent with a material fact or factual assumption or is

implausible if it appears to be based on facts that are inconsistent with the facts of the transaction.

(iii) If the fair market value of property or the expected financial performance of an investment is relevant, a practitioner may not accept an appraisal or financial projection as support for the matters claimed therein unless –

(A) The appraisal or financial projection makes sense on its face;

(B) The practitioner reasonably believes that the person making the appraisal or financial projection is reputable and competent to perform the appraisal or projection; and

(C) The appraisal is based on the definition of fair market value prescribed under the relevant Federal tax provisions.

(iv) If the fair market value of purchased property is to be established by reference to its stated purchase price, the practitioner must examine the terms and conditions on which the property was (or is to be) purchased to determine whether the stated purchase price reasonably may be considered to be its fair market value.

(2) Relate law to facts. The opinion must relate the applicable law to the relevant facts.

(i) The opinion must clearly identify the facts upon which the opinion's conclusions are based.

(ii) The opinion must contain a reasoned analysis of the pertinent facts and legal authorities and must not assume the favorable resolution of any Federal tax issue material to the analysis or otherwise rely on any unreasonable legal assumptions.

(iii) The opinion must not contain inconsistent legal analyses or conclusions with respect to different Federal tax issues.

(iv) The practitioner must ascertain that all material Federal tax issues have been considered, and that all of those issues as to which there is a realistic possibility of a successful denial of the claimed tax benefits have been fully and fairly addressed. The opinion must state that the practitioner has considered the possible application to the facts of all reasonably relevant judicial doctrines, including the step transaction, business purpose, economic substance, substance over form, and sham transaction doctrines, as well as reasonably relevant statutory and regulatory anti-abuse rules. In analyzing such judicial doctrines and statutory and regulatory anti-abuse rules, the opinion must take into account the taxpayer's non-tax and tax purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. For purposes of this section 10.35, a material Federal tax issue is any Federal tax issue the resolution of which could have a significant impact (whether beneficial or adverse) on a taxpayer under any reasonably foreseeable circumstance.

(3) Evaluation of material Federal tax issues and overall conclusion. The practitioner must clearly state in the opinion his or her conclusion as to the likelihood that an investor (or, where the practitioner is relying on a representation as to the characteristics of potential investors, a typical investor of the type to whom the transaction is or will be marketed) will prevail on the merits with respect to each material Federal tax issue that involves a realistic

possibility of a successful denial of the claimed tax benefits. This requirement is not satisfied by including a statement in the opinion that the practitioner was unable to opine with respect to certain material Federal tax issues, including but not limited to whether the transaction has a business purpose or economic substance.

(i) The opinion must either –

(A) Unambiguously reach an overall conclusion that the Federal tax treatment of the tax item or items discussed in the opinion is more likely than not (or at a higher level of confidence) the proper tax treatment; such overall conclusion may not be based solely on the conclusion that the taxpayer more likely than not will prevail on the merits of each material Federal tax issue; or

(B) State that the practitioner is unable to reach an overall conclusion that the Federal tax treatment of the tax issues is more likely than not the proper treatment, and state that the opinion cannot be relied on by the taxpayer to whom the opinion is rendered (or in the case of a marketed by third parties, by any taxpayer) as a basis for establishing (i) under section 6662(d)(2)(C)(i)(II) of the Internal Revenue Code that a taxpayer other than a corporation reasonably believed at the time a tax return was filed that the tax treatment of the item was more likely than not the proper treatment of that item, or (ii) under section 6664(c)(1) of the Internal Revenue Code that a corporate taxpayer acted with reasonable cause and in good faith with respect to a tax item.

(ii) In ascertaining that all material Federal tax issues have been considered and that all which involve a realistic possibility of a successful denial of the claimed tax benefits have been fully and fairly addressed, and in evaluating the merits of those issues and evaluating

whether the Federal tax treatment of the tax item or items is the proper tax treatment, 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 may not be taken into account.

(4) Description of opinion. The practitioner must take reasonable steps to assure that any written materials or promotional efforts that distribute, reflect or refer to the opinion, correctly and fairly represent the nature and extent of the opinion.

(5) Competence to provide opinion; reliance on opinions of others. The practitioner must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered. If the practitioner is not sufficiently knowledgeable to render an informed opinion with respect to particular material Federal tax issues, then the practitioner may rely on the opinion of another practitioner with respect to such issues, provided the practitioner is satisfied that the other practitioner is sufficiently knowledgeable regarding such issues and the practitioner does not have reason to believe or actual knowledge that such opinion should not be relied on. The practitioner also must be satisfied that the combined analysis, taken as a whole, satisfies the requirements of paragraph (c).

(6) Financial forecasts and projections. A practitioner who makes a report with financial forecasts or projections relating to or based on the tax consequences of items that are included in written materials disseminated to any or all of the same persons as the opinion of another practitioner may rely on the opinion as to any or all material Federal tax issues, provided that the practitioner who desires to rely on the other opinion (i) does not have reason to believe or actual knowledge that the practitioner rendering such other opinion has not complied with the standards of paragraph (c), (ii) is satisfied that the other practitioner is sufficiently knowledgeable, and

(iii) does not know and has no reason to believe that the opinion of the other practitioner should not be relied on. The practitioner's report must disclose any material Federal tax issue not covered by, or incorrectly opined on, by the other opinion, and shall set forth his or her opinion with respect to each such issue in a manner that satisfies the requirements of paragraph (c).

(d) Effect of opinion that meets compliance requirements. An opinion of a practitioner that meets the requirements of paragraph (c) will satisfy the practitioner's responsibilities under this section 10.35, 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 separately determined under applicable provisions of the law and regulations.

(e) Advisory Committee to Director of Practice. For purposes of advising the Director of Practice whether an individual may have violated section 10.35, the Director is authorized to establish an Advisory Committee composed of at least five individuals authorized to practice before the Internal Revenue Service and which shall include at least one attorney, at least one certified public accountant, at least one enrolled agent, and at least one enrolled actuary. Under procedures established by the Director, such Advisory Committee will, at the request of the Director, review and make recommendations with regard to the alleged violations of section 10.35.