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Standards of Practice for Pension Practitioners, 39 J. Marshall L. Rev. 667 (2006)

David Pratt

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STANDARDS OF PRACTICE FOR PENSION PRACTITIONERS

DAVID PRATT*

I. INTRODUCTION

Pension practitioners may be subject to several different sets of ethical rules. First, there are the rules governing the practice of the particular profession (attorney,¹ actuary, accountant, etc.) to

* Professor of Law, Albany Law School. Thanks to the editors of the John Marshall Law Review for all of their help and hard work in preparing this article for publication. Thanks also to W. Thomas Reeder, Esq., for the enjoyable and educational experience of speaking with him on this topic at the L.A. Benefits Conference in Los Angeles in January, 2006. He is not responsible for anything contained in the text. The article is dedicated to my son Nick, in recognition of his May, 2006 graduation (summa cum laude) from Albany Law School.

1. For an excellent discussion of the ethical considerations affecting attorneys who practice employee benefits law, see Gwen Thayer Handelman et al., *Ethics, Privilege, and Related Issues in Employee Benefits Practice*, ALI-ABA COURSE OF STUDY MATERIALS: FUNDAMENTALS OF EMPLOYEE BENEFITS LAW: 719, 723 (Feb. 26, 2004).

Employee benefits practitioners are confronted with a difficult array of ethical issues arising from entity, multiple, and fiduciary representation. Employee benefits practice is particularly likely to raise issues of client identity, conflicts of interest, attorney-client privilege, and confidentiality. Navigating through these complicated issues, which are commonly subject to multiple standards of professional conduct, is hazardous. In representing entities, multiple parties, or fiduciaries, an employee benefits lawyer must take care to identify the client—which may be a plan or plan sponsor, an individual, or plan participants, depending upon the circumstances and the jurisdiction—to understand the confidentiality and conflicts issues that pervade plan administration and litigation. Having determined the identity of the client(s) under the applicable law as applied in the circumstances, the lawyer should behave consistently with that determination. The Employee Retirement Income Security Act of 1974 (ERISA) establishes few standards of conduct for lawyers beyond prohibiting excessive fees and self-dealing under the prohibited transaction rules. ERISA fiduciary standards generally do not apply to lawyers to the extent they act solely as lawyers, although a lawyer may become a fiduciary, and thus subject to fiduciary standards, under ERISA's functional definition. Regulation of ERISA lawyers was left primarily to state law, which generally is based on ethical standards promulgated by the American Bar Association (ABA).

which the individual belongs. Second, if the individual practices before the Internal Revenue Service (“IRS” or “the Service”), he or she must meet the standards of practice promulgated by the Treasury Department and IRS. Third, the individual must comply with the ethical rules issued by professional organizations (such as the American Academy of Actuaries (“AAA”), the National Institute of Pension Administrators (“NIPA”) or the American Society of Pension Professionals and Actuaries (“ASPPA”) to which he or she belongs.²

There have been three particularly important recent developments. First, as part of its battle against abusive tax shelters, the IRS has identified several “listed transactions” involving employee benefit plans.³ Second, the American Jobs Creation Act of 2004 (“JOBS Act”) has greatly increased the penalties that may be imposed in connection with abusive tax shelters.⁴ Finally, in December 2004 the IRS issued detailed new regulations governing standards of practice.⁵ This article will discuss each of these issues and will focus on the new regulations.

The IRS standards of practice are enforced by the IRS Office of Professional Responsibility (“OPR”), which was established in January 2003, and replaced the Office of the Director of Practice.⁶ In December 2003, IRS Commissioner, Mark W. Everson, appointed Cono Namorato as Director of OPR.⁷ Since 2003, OPR has doubled its size to 50 employees, tripled the number of OPR enforcement attorneys, and expects to have an additional increase in staff. Namorato has stated that he intends to pursue high impact tax cases that, he hopes, will lead to a change in overall

Id. See also Sherwin P. Simmons, *Who Are the ERISA Clients? Plan Fiduciaries or Plan Participants?*, 55 TAX NOTES 1240, 1242 (1992) (discussing the attorney-client privilege).

2. Enrolled actuaries are also subject to the regulations issued by the Joint Board for the Enrollment of Actuaries, Regulations Governing the Performance of Actuarial Services Under the Employee Retirement Income Security Act of 1974. See 20 C.F.R. § 901 (1974). See also Investment Adviser Codes of Ethics, 69 Fed. Reg. 4040 (proposed Jan. 27, 2004) (requiring registered advisers to adopt codes of ethics.) Other professional organizations such as the International Foundation of Employee Benefit Plans (IFEBC), Ethical Considerations for Trustees of Multiemployer Plans, and the California Public Employees’ Retirement System (CalPERS) Code of Ethics for External Money Managers create standards that may have to be complied with.

3. I.R.S. Notice 2004-67, 2004-2 C.B. 600.

4. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1419 (2004). See also discussion *infra* Parts II.C-D.

5. Regulations Governing Practice Before the Internal Revenue Service, 69 Fed. Reg. 75839 (Dec. 20, 2004) (to be codified at 31 C.F.R. pt. 10). See also discussion *infra* in Part IV.

6. Preamble to Proposed Regulations Governing Practice Before the Internal Revenue Service, 71 Fed. Reg. 6421, 6422 (proposed Feb. 8, 2006).

7. I.R.S. News Release, IR-2003-148 (Dec. 29, 2003).

practitioner behavior. OPR is actively soliciting sanction referrals from the divisions of the IRS. In addition, OPR publishes the names of sanctioned practitioners in the Internal Revenue Bulletin and will notify the disciplined practitioner's state board of the sanction.⁸ "[T]he OPR is using all the tools available to it to enforce Circular 230 provisions, old and new."⁹

II. LISTED TRANSACTIONS AND TAX SHELTERS

A. *In General*

Taxpayers that participate, directly or indirectly, in a listed transaction (or other "reportable transaction")¹⁰ must disclose the transaction to the Service by attaching a statement (Form 8886) to their tax return for each taxable year for which their federal income tax liability is affected by participation in the transaction.¹¹

A "listed transaction" is a transaction that is the same as, or substantially similar to, one that the IRS has determined to be a tax avoidance transaction and has identified by an IRS notice or other form of published guidance.¹²

It is not always easy to tell whether a client "participates" in a listed transaction. Under the regulations, a "taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in published guidance that lists the transaction" or "if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance that lists a transaction."¹³ The

8. Office of Professional Responsibility Steps Up Enforcement Efforts, CCH 2004 Tax Day, Item #I.8 (Nov. 8, 2004); Kenneth A. Gary, *Expect New Regs, Enforcement on Circular 230, Says IRS Official*, 44 TAX. PRAC. 229 (Dec. 17, 2004). Under the proposed regulations issued in February, 2006, all hearings, reports, evidence and decisions in disciplinary proceedings will generally be available for public inspection. Regulations Governing Practice Before the Internal Revenue Service, 71 Fed. Reg. 6421 (proposed Feb. 8, 2006) (to be codified at 31 C.F.R. pt. 10).

9. Sheryl Stratton, *Clarity Needed on Circular 230 Regs, Practitioners Say*, 45 TAX. PRAC. 115 (Feb. 18, 2005).

10. There are six types of reportable transactions: (1) listed transactions; (2) transactions marketed under conditions of confidentiality; (3) transactions with contractual protection; (4) transactions generating a tax loss exceeding specified amounts; (5) transactions resulting in a book-tax difference exceeding \$10 million; and (6) transactions generating a tax credit when the underlying asset is held for a brief period of time (45 or fewer days). Treas. Reg. § 1.6011-4(b) (2006).

11. Treas. Reg. § 1.6011-4(a), (d).

12. Treas. Reg. § 1.6011-4(b)(2).

13. Treas. Reg. § 1.6011-4(c)(3)(i)(A). Published guidance may identify other types or classes of persons that will be treated as participants in a listed transaction. *Id.*

term “tax benefit” is defined broadly, to include “deductions, exclusions from gross income, nonrecognition of gain, tax credits, adjustments (or the absence of adjustments) to the basis of property, status as an entity exempt from Federal income taxation, and any other tax consequences that may reduce a taxpayer’s Federal income tax liability by affecting the amount, timing, character, or source of any item of income, gain, expense, loss, or credit.”¹⁴

B. Listed Transactions

The IRS has identified several transactions involving employee benefit plans as listed transactions:¹⁵

- Accelerated deductions for contributions to 401(k) plans (contributions attributable to compensation earned after the end of the taxable year);¹⁶
- S Corporation ESOPs: abuse of the delayed effective date for Internal Revenue Code (Code) section 409(p);¹⁷
- S Corporation ESOPs: certain business structures held to violate Code section 409(p);¹⁸
- Collectively bargained welfare benefit funds under Code section 419A(f)(5);¹⁹
- Certain trust arrangements seeking to qualify for exemption from the deduction limitations under Code section 419 as 10-or-more employer plans;²⁰
- Abusive Roth IRA transactions;²¹
- Deductions for excess life insurance in a section 412(i) or other defined benefit plan.²²

It is not always easy to determine whether a transaction is the same as, or substantially similar to, a listed transaction. Some

14. Treas. Reg. § 1.6011-4(c)(6).

15. I.R.S. Notice 2004-67, 2004-2 C.B. 600. *See also* I.R.S., Abusive Tax Transactions – Listed Transactions, www.irs.gov/retirement/article/0,,id=119551,00.html.

16. *See* Rev. Rul. 90-105, 1990-2 C.B. 69; Rev. Rul. 2002-73, 2002-2 C.B. 805; Rev. Rul. 2002-46, 2002-2 C.B. 117.

17. *See* Rev. Rul. 2003-6, 2003-3 I.R.B. 286. All references in this article to the “Internal Revenue Code” or “Code” are references to the Internal Revenue Code of 1986, as amended, which constitutes Title 26 of the U.S. Code.

18. Rev. Rul. 2004-4, 2004-6 I.R.B. 414.

19. I.R.S. Notice 2003-24, 2003-1 C.B. 853.

20. Rev. Rul. 95-34, 1995-1 C.B. 309; 10 or More Employer Plans, 68 Fed. Reg. 42254 (July 17, 2003) (to be codified at 26 C.F.R. pts. 1, 602); *Neonatology Associates, P.A. v Comm’r. of Internal Revenue*, 299 F.3d 221 (3d Cir. 2002).

21. I.R.S. Notice 2004-8, 2004-4 I.R.B. 333.

22. *Value of Life Ins. Contracts When Distributed From a Qualified Retirement Plan*, 70 Fed. Reg. 50967, (Aug. 29, 2005) (to be codified at 26 C.F.R. pt. 1); Rev. Proc. 2005-25, 2005-17 I.R.B. 962; Rev. Rul. 2004-20, 2004-10 I.R.B. 546; Rev. Rul. 2004-21, 2004-10 I.R.B. 544.

welfare benefit funds are legitimate. If a taxpayer uses a traditional IRA rather than a Roth IRA, is that “substantially similar” to the Roth IRA listed transaction? Under the regulations, the term “substantially similar” includes “any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy” and “must be broadly construed in favor of disclosure.”²³

When the determination is unclear, the practitioner has a dilemma. Recommending disclosure is likely to upset the client, but failure to disclose may expose the client to accuracy-related penalties. The regulations provide that a taxpayer’s failure to disclose a reportable transaction is a strong indication that the taxpayer failed to act in good faith.²⁴ The Service will rule on whether a specific transaction is a listed transaction that should be disclosed, so it is possible to obtain a definitive answer.²⁵ Nevertheless, the time and the cost involved in obtaining such a determination make it unlikely that many taxpayers will obtain them.

The benefits-related listed transactions can affect both small and large clients, and do not always involve large amounts. The pension advisor may be only peripherally involved, if at all, in a transaction that is strongly recommended by another advisor. The client may be unwilling to pay for a thorough review of a proposed transaction, but may ask an attorney or CPA just to take a quick look at it. Under the new standards for opinions,²⁶ the prudent advisor will decline any such invitation.

C. *The American Jobs Creation Act of 2004*²⁷

Subtitle B of Title VIII of the Jobs Act includes provisions relating to tax shelters.²⁸ These provisions are of concern to benefits practitioners because the IRS has identified several benefits transactions as “listed transactions.”

The act penalizes in several ways taxpayers who fail to disclose reportable transactions. First, the act imposes new monetary penalties on taxpayers that fail to disclose a reportable transaction, which penalties will apply even if the taxpayer prevailed on the merits of the transaction. Next, it significantly increases the accuracy-related penalties for nondisclosed reportable transactions. The act also requires taxpayers to disclose in SEC filings the

23. Treas. Reg. § 1.6011-4(c)(4) (2005).

24. Treas. Reg. § 1.6664-4(d).

25. Treas. Reg. § 1.6011-4(f).

26. See *infra* Section IV.

27. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 [hereinafter JOBS Act].

28. JOBS Act §§ 811-845.

imposition of any monetary penalty for nondisclosure of a listed transaction, any enhanced accuracy-related penalty for a nondisclosed transaction, or any gross valuation misstatement penalty imposed for a reportable transaction. Finally, the act extends the statute of limitations for nondisclosed listed transactions and denies any deduction for interest paid regarding any deficiency relating to a nondisclosed reportable transaction.²⁹

The Jobs Act added the following new sentence to 31 U.S.C. section 330(b):

The Secretary may impose a monetary penalty on any representative described in the preceding sentence. If the representative was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to such penalty, the Secretary may impose a monetary penalty on such employer, firm, or entity if it knew, or reasonably should have known, of such conduct. Such penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty and may be in addition to, or in lieu of, any suspension, disbarment, or censure of the representative.³⁰

This applies to actions taken after the date of the enactment.³¹ The Jobs Act also added the following new section 330(d):

Nothing in this section or in any other provision of law shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion.³²

According to the preamble to the December 2004 final regulations:³³

[the Jobs Act] amended section 330 of title 31 of the United States Code to clarify that the Secretary may impose standards for written advice relating to a matter that is identified as having a potential for tax avoidance or evasion. The Act also authorizes the Treasury Department and the IRS to impose a monetary penalty against a practitioner who violates any provision of Circular 230.

29. Elaine Church, et al. *Penalties Put Teeth in Tax Shelter Disclosure Requirements*, TAX NOTES TODAY, Oct. 29, 2004, available at LEXIS, Fedtax Library 2004 TNT 210-18; see also Burgess J.W. Raby & William L. Raby, *JOBS Act Penalty Provisions and Tax Practitioners*, TAX NOTES TODAY, Oct. 28, 2004, available at LEXIS, Fedtax Library 2004 TNT 209-51; Herbert N. Beller, *The New Penalty Regime: Proceed with Caution!*, THE TAX EXECUTIVE, Nov. 2004 (discussing the new set of penalties detailed in the JOBS Act of 2004).

30. JOBS Act § 822 (a)(1)(B) (enacting 31 U.S.C. § 330(b)).

31. JOBS Act at § 822(a)(2).

32. JOBS Act at § 822(b) (amending 31 U.S.C. § 330(d)).

33. Regulations Governing Practice Before the Internal Revenue Service, 69 Fed. Reg. 75839 (Dec. 20, 2004) (to be codified at 31 C.F.R. pt. 10).

D. Potential Penalties

Prior to its amendment, Code Section 6662 imposed an accuracy-related penalty in an amount equal to 20% of the portion of an underpayment attributable to, among other things, (1) “negligence or disregard of rules or regulations” or (2) “any substantial understatement of income tax.”³⁴

The Jobs Act significantly increased the accuracy-related penalties for non-disclosed reportable transactions. If the transaction was disclosed adequately, a 20% penalty is imposed; if not, the penalty increases to 30%.³⁵ The penalty will be severe, even if the taxpayer has little or no current tax liability. The penalty is based on the amount of the understatement of tax, determined at the highest corporate or individual tax rate, without regard to the taxpayer’s actual taxable income for the year.³⁶ Thus, the understatement will generally be the amount of the deduction or loss disallowed, multiplied by the highest marginal tax rate. If the taxpayer adequately disclosed the transaction, the penalty may be waived if the taxpayer acted in good faith and satisfies a stringent reasonable cause exception.³⁷ If the taxpayer failed to disclose the transaction adequately, the penalty may not be waived under any circumstances.³⁸ For items attributable to a tax shelter, there are special rules to determine whether the penalty applies. Generally, to escape the penalty, the taxpayer must demonstrate reasonable cause and good faith under Code section 6664.³⁹

Prior to the enactment of the Jobs Act, the law did not specifically authorize the IRS to impose a monetary penalty on taxpayers who failed to disclose their participation in a reportable transaction. There are several different categories of reportable transaction. Listed transactions are one of those categories.⁴⁰ The Jobs Act imposed new monetary penalties on taxpayers that fail to disclose a reportable transaction, which will apply even if the taxpayer prevails on the merits of the transaction.⁴¹ For an individual, the penalty for failure to disclose a listed transaction is \$100,000. The penalty is \$200,000 for a corporation.⁴² The penalties apply separately to each transaction that a taxpayer fails

34. 26 U.S.C. § 6662 (prior to amendment by JOBS Act §§ 812, 819).

35. 26 U.S.C. § 6662A(a) (enacted by JOBS Act § 812).

36. 26 U.S.C. § 6662A(b) (enacted by JOBS Act § 812).

37. 26 U.S.C. § 6664(d)(1) (enacted by JOBS Act § 812).

38. 26 U.S.C. § 6664(d)(2) (enacted by JOBS Act § 812).

39. 26 U.S.C. 6664(c)(1).

40. See Treas. Reg. § 1.6011-4(b), see also *supra* note 10 (describing six types of reportable transactions).

41. 26 U.S.C. 6707A (enacted by JOBS Act § 811); H. REP. NO. 108-755, Oct. 7, 2004, at 584.

42. 26 U.S.C. § 6707A(b)(2)(B).

to disclose on any return, and no penalty imposed with respect to a listed transaction can be waived under any circumstances.⁴³

The Jobs Act also requires taxpayers to disclose in SEC filings the imposition of any monetary penalty for nondisclosure of a listed transaction, any enhanced accuracy-related penalty for a non-disclosed transaction, or any gross valuation misstatement penalty imposed for a reportable transaction.⁴⁴ Failure to make any required SEC disclosure is treated as a separate failure to disclose a listed transaction and thus is subject to an additional penalty of \$200,000, which must also be disclosed to the SEC.⁴⁵

In addition, effective for tax years for which the statute of limitations for assessing a deficiency had not expired before the date of enactment, the Jobs Act extends the statute of limitations, if a taxpayer fails to disclose a listed transaction on any return or statement, for any tax year for which disclosure is required. The statute is extended, solely with respect to the listed transaction, until one year after the date on which the transaction is disclosed to the IRS, either by the taxpayer or by a material adviser.⁴⁶ Thus, if the listed transaction is not disclosed, the statute of limitations remains open indefinitely. Under a long-established rule, the statute of limitations also remains open indefinitely if the taxpayer's return is fraudulent,⁴⁷ even if the taxpayer later files an amended non-fraudulent return. However, it is far easier for the IRS to prove a failure to disclose than to prove fraud.

Finally, the Jobs Act denies any deduction for interest paid regarding any deficiency relating to a non-disclosed reportable transaction.⁴⁸

The IRS has now issued interim guidance on the new penalty provisions.⁴⁹

43. 26 U.S.C. § 6707A(d)(1).

44. 26 U.S.C. § 6706A(e), (enacted by JOBS Act § 814(a)).

45. *Id.*

46. 26 U.S.C. § 6501(c)(10), (enacted by JOBS Act § 814(a)).

47. 26 U.S.C. § 6501(c)(1).

48. *Id.*

49. See I.R.S. Notices 2005-11, 2005-7 I.R.B. 493, and 2005-12, 2005-7 I.R.B. 494; see also Sheryl Stratton, *Interim Disclosure and Understatement Penalty Guidance Issued*, TAX NOTES TODAY, Jan. 21, 2005, available at LEXIS, Fedtax Library, 2005 TNT 13-2.

III. STANDARDS OF TAX PRACTICE⁵⁰

A. PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

The regulations governing practice before the IRS are found in Part 10 of Title 31 of the Code of Federal Regulations (CFR), and are often referred to as “Circular 230.” Under the regulations:

Practice before the Internal Revenue Service comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, and representing a client at conferences, hearings, and meetings.⁵¹

The definition is clearly not limited to activities that require the taxpayer to give the representative a power of attorney (IRS Form 2848).

As the New York State Bar Association (NYSBA) has pointed out, the regulations appear to assume that all written tax advice falls within the scope of “practice before the IRS,” but this assumption is questionable.⁵² This concern as to the scope of the definition is exacerbated by the February 2006, proposed regulations, which would add the words “rendering written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion” to clarify that the rendering of tax advice is practice

50. See also IRS Publication 947, Practice Before the IRS and Powers of Attorney (stating standards for tax practice). For additional guidance for attorneys, see the website of the ABA Section of Taxation, Standards of Tax Practice Committee, www.abanet.org, and ABA Formal Opinions 314, 346 and 85-352. For additional guidance for CPAs, see the AICPA Statements on Standards for Tax Services, www.aicpa.org. SEC regulations promulgated under the Sarbanes-Oxley Act of 2002 govern benefits practice involving advice to an issuer about U.S. securities laws. [Implementation of Standards of Professional Conduct for Attorneys, 68 Fed Reg. 6296 (Feb. 6, 2003), codified at 17 C.F.R. Part 205].

51. 31 C.F.R. § 10.2(d)(2006).

52. NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT NO. 1081, REPORT ON CIRCULAR 230 REGULATIONS, March 3, 2005 (the “NYSBA Report”), reprinted as David Horiton, *NYSBA Seeks Reconsideration of Circular 230 Rules*, 2005 TNT 43-56, March 3, 2005. As the report notes: “The Preamble to the December Regulations states that the scope of the Regulations is “limited to practice before the IRS.” This is appropriate, because the statute that contemplates the December Regulations, Section 330 of Title 31 of the United States Code, contemplates regulation of practice before the Treasury. The December Regulations appear to assume that all written tax advice falls within the purview of this limitation. We question whether this assumption is correct.”

before the IRS, and thus subject to the requirements of Circular 230, when provided by a practitioner.⁵³

The original purpose of the 2004 regulations was to impose new requirements for legal opinions that specifically address and reach conclusions concerning the tax treatment of investments in tax shelters. Accordingly, the regulations focus on this type of advice.

Most of the work of employee benefits professionals does not consist of giving advice, in this sense, still less giving tax advice. For example, an actuary who sends a client a report stating the minimum required contribution and maximum deductible contribution for a plan year is not giving tax advice, in the usual sense of that term. However, the report does (at least implicitly) advise the client that the recommended contribution will be deductible under Code section 404, and will satisfy the minimum funding rules of section 412. The regulations are so broadly drawn that it is difficult to be confident that such activities will not be swept into the net.⁵⁴

B. Which Individuals Are Required to Comply With the Regulations?

The individuals who may practice before the IRS include attorneys, CPAs, enrolled agents, and enrolled actuaries.⁵⁵ The term “practitioner” means a person in any of these four categories.⁵⁶ However, practice as an enrolled actuary is limited to representation with respect to issues involving specified sections of the Code.⁵⁷

Some commentators, including a former IRS Chief Counsel, believe that advisors who are not “practitioners” are also at risk.⁵⁸

53. See Preamble to the Proposed Regulations, 71 Fed. Reg. 6421, 6422, Feb. 8, 2006 (discussing proposed regulations).

54. See Donald J. Segal, *Actuaries Seek Technical Advice on Circular 230*, TAX NOTES TODAY, Nov. 25, 2005, available at LEXIS, Fedtax Library, 2005 TNT 226-11 [hereinafter Academy Letter].

We do acknowledge that our clients often expect to rely on our calculations for their tax purposes. For example, we would not expect to tell a client that our calculation of the amount to be contributed and deducted could not be used for the purpose of avoiding penalties that may be imposed in the event of a challenge. Nevertheless, we see a significant distinction between this form of reliance and reliance on a covered opinion. To a great extent, our clients' reliance is simply reliance on the accuracy of our mathematical calculations and the exercise of our professional judgment in selecting actuarial assumptions—an exercise that is required by tax law.

Id.

55. 31 C.F.R. §10.3.

56. 31 C.F.R. §10.2(e).

57. 31 C.F.R. §10.3(d)(2).

58. Crystal Tandon, *Engineers Could Get Caught by Circular 230*, Says

IRS Chief Counsel Don Korb, however, has pointed out that “Circular 230’s sections 10.35 and 10.37, which lay out rules for covered opinions and other written advice, are written explicitly for practitioners, which, as defined by section 10.2(e), consist of four groups—attorneys, accountants, enrolled agents, and, in some cases, enrolled actuaries.” He did accept, however, that section 10.50, which outlines rules for disqualifying appraisers from presenting evidence or testimony before the Treasury Department or the IRS, could cause some “heartburn” for groups outside the four listed categories.⁵⁹

The IRS Advisory Committee on Tax Exempt and Governmental Entities has recommended that a new category of practitioners be created, enrolled retirement plan agents.⁶⁰ These

Former Chief Counsel, TAX NOTES TODAY, June 7, 2005, available at LEXIS, Fedtax Library, 2005 TNT 108-2.

Williams pointed out that under [the Act], anyone who gives a tax opinion covering federal tax issues in connection with an arrangement or plan that has a significant tax avoidance purpose is deemed to be practicing before the IRS. That is a change from prior law, which required practitioners to have a power of attorney authorizing representation before the IRS for Circular 230 to apply. Asked whether cost-segregation studies—which are used to determine the asset class of property for depreciation purposes—or valuation studies could be covered opinions under Circular 230, Jonathan Zelnik, senior counsel to the IRS chief counsel, said, “To the extent it raises tax issues, I do think it would be covered.” Zelnik emphasized, however, that this was his belief and that he was speaking on his own behalf.

Id.

59. Allen Kenny, *Korb: Use Common Sense When It Comes To Circular 230*, 107 TAX NOTES 1636 (June 27, 2005).

60. Christopher Quay, *Exempt Advisory Committee Recommends Creation of Enrolled Retirement Plan Agents Under Circular 230*, TAX NOTES TODAY, June 9, 2005, available at LEXIS, Fedtax Library, 2005 TNT 110-6. The preamble to the February, 2006, proposed regulations states that:

The Advisory Committee for Tax Exempt/Governmental Entities recently suggested that individuals who provide technical services to plan sponsors to maintain the tax qualified status of their retirement plans (retirement plan administrators) should be authorized to practice provided they demonstrate the competency to do so. The Treasury Department and the IRS are considering this proposal and invite public comments even though text is not proposed in this notice of proposed rulemaking. The Advisory Committee’s proposal suggests limiting the practice by this group of individuals to representation relating to filing applications for determination letters, Forms 5500, employee plan audits, and negotiating with the IRS with respect to voluntary compliance matters. In addition, the Advisory Committee proposes procedures for enrollment similar to the current Enrolled Agent program (see §§ 10.4-10.6), including an examination to determine competency, a renewal process and continuing professional education requirements. For more information relating to practice by retirement plan administrators, see ESTABLISHING THE ENROLLED RETIREMENT PLAN AGENT UNDER CIRCULAR 230, ADVISORY COMMITTEE FOR TAX EXEMPT/GOVERNMENTAL ENTITIES (June 2005). The Treasury

ERPAs (the male equivalent of SHERPAs?) would certainly be subject to the regulations. Any individual may appear on his or her own behalf and, in some cases, may represent someone else (e.g., a member of his or her immediate family). Any individual may prepare a tax return, appear as a witness for the taxpayer before the IRS, or furnish information requested by the IRS.⁶¹

A related question is whether an employee benefits professional may be subjected to state disciplinary proceedings for the unauthorized practice of a regulated profession. In *The Florida Bar Re: Advisory Opinion Nonlawyer Preparation of Pension Plans*,⁶² the Florida Bar petitioned the court to approve an opinion that would have defined certain employee benefit services performed by non-lawyers, including the design and drafting of pension plans, as the unlicensed practice of law. The Florida Supreme Court disapproved the proposed opinion, holding that its authority was restricted by Circular 230. The decision suggests that a lawyer or non-lawyer admitted to practice before the IRS is authorized by the Circular 230 regulations to engage in employee benefits practice anywhere in the country. However, it seems that a benefits professional who is not a “practitioner”, as defined in those regulations, is potentially subject to state disciplinary proceedings.

C. General Rules

“A practitioner who, having been retained by a client with respect to a matter administered by the [IRS], knows that the

Department and the IRS also invite comments on proposals relating to limited practice by other individuals that the public believes competent to represent taxpayers before the IRS, and whether the Director of the Office of Professional Responsibility should have the authority to regulate these individuals through IRS notice procedures.

[71 Fed. Reg. 6421, 6422, Feb. 8, 2006]

61. 31 C.F.R. § 10.7. The preamble to the February, 2006, proposed regulations notes that:

Section 10.7(c)(1)(viii) currently authorizes an individual, who is not otherwise a practitioner, to represent a taxpayer during an examination if that individual prepared the return for the taxable period under examination. The proposed regulations revoke this authorization because it is inconsistent with the requirement that all individuals permitted to practice before the IRS demonstrate their qualifications to advise and assist persons in presenting their cases to the IRS . . . Revocation of the authority for limited practice will not preclude a return preparer from assisting a taxpayer in responding to questions regarding the taxpayer’s return. The proposed regulations do not preclude an unenrolled return preparer from accompanying a taxpayer to an examination, provided the taxpayer authorizes the IRS to disclose confidential tax information to the unenrolled return preparer.

71 Fed. Reg. 6421, 6423, Feb. 8, 2006.

62. *The Florida Bar re Advisory Opinion*, 571 So. 2d 430 (Fla., 1990).

client has not complied with the revenue laws . . . , or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under [those laws],” must advise the client promptly of that fact and of the consequences.⁶³

“A practitioner may not charge an unconscionable fee for representing a client in a matter before the [IRS].” In addition, “[a] practitioner may not charge a contingent fee for preparing an original tax return or for any advice rendered in connection with a position taken or to be taken on an original tax return.” A contingent fee may be charged, however, “for preparation of or advice in connection with an amended tax return or a claim for refund (other than a claim for refund made on an original tax return), but only if the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended tax return or refund claim will receive substantive review by the [IRS].”⁶⁴

“In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her Federal tax obligations. The practitioner may retain copies of the records The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibility.” However, if applicable state law allows the retention of a client’s records in the case of a dispute over fees, “the practitioner need only return those records that must be attached to the taxpayer’s return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records . . . retained by the practitioner . . . that are necessary for the client to comply with his or her Federal tax obligations.”⁶⁵

63. 31 C.F.R. § 10.21.

64. 31 C.F.R. § 10.27. The proposed regulations would add new restrictions:

Most commentators opposed further limitations on contingent fees under § 10.27. The Treasury Department and the IRS continue to believe that a rule restricting contingent fees for preparing tax returns supports voluntary compliance with the Federal tax laws by discouraging return positions that exploit the audit selection process. Additionally, a broader prohibition against contingent fee arrangements is appropriate in light of concerns regarding attorney and auditor independence. The recent shift toward even greater independence, including rules adopted by the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board, also support expanding the prohibition on contingent fees with respect to Federal tax matters.

Preamble to proposed regulations, 71 Fed. Reg. 6421, 6423-6424, Feb. 8, 2006.

65. 31 C.F.R. § 10.28.

D. Conflicts of Interest

Generally, a practitioner may not represent a client in his or her practice before the IRS if the representation involves a conflict of interest.⁶⁶ A conflict of interest exists if:

- (1) The representation of one client will be directly adverse to another client; or
- (2) There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person or by a personal interest of the practitioner.

Notwithstanding the existence of a conflict of interest, the practitioner may represent a client if:

- (1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;
- (2) The representation is not prohibited by law;
- (3) Each affected client gives informed consent, confirmed in writing.

Copies of the consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients and the written consents must be provided to any officer or employee of the IRS on request.⁶⁷

These rules parallel, but are not identical to, the ethics rules for attorneys.⁶⁸ For example, "Unlike the Model Rules, which permit affected clients to provide informed consent orally if the consent is contemporaneously documented by the practitioner in writing, an oral consent followed by a confirmation letter authored by the practitioner will not satisfy § 10.29 unless the confirmation letter is countersigned by the client."⁶⁹

*E. Tax Returns*⁷⁰

A practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic possibility standard) unless the position is not frivolous and is adequately disclosed to the [IRS].⁷¹ A practitioner may not

66. 31 C.F.R. § 10.29.

67. *Id.*

68. MODEL RULES OF PROF'L CONDUCT, R. 1.7; 1.13.

69. Preamble to Proposed Regulations, 71 Fed. Reg. 6421, 6424, Feb. 8, 2006 (to be codified at 31 C.F.R. pt. 10).

70. 31 C.F.R. § 10.34 (a).

71. *Id.*

advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless –

1) The practitioner determines that the position satisfies the realistic possibility standard; or

(2) The position is not frivolous and the practitioner advises the client of any opportunity to avoid the accuracy-related penalty under section 6662 of the . . . Code by adequately disclosing the position and of the requirements for adequate disclosure.⁷²

. . . .

A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, must inform the client of the penalties reasonably likely to apply to the client with respect to the position advised, prepared, or reported. The practitioner also must inform the client of any opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure.⁷³

. . . .

A practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner. . . . [Furthermore, the practitioner] must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.⁷⁴

For purposes of these rules:

(1) *Realistic possibility.* A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis of the law and the facts by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits. The authorities described in 26 C.F.R. 1.6662-4(d)(3)(iii), or any successor provision, of the

72. *Id.* The February 2006 proposed regulations would revise section 10.34(b) to read as follows:

(1) A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous. (2) A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service— (i) The purpose of which is to delay or impede the administration of the Federal tax laws; (ii) That is frivolous or groundless; or (iii) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation.

Preamble to proposed regulations, 71 Fed. Reg. 6421, 6423-6424, Feb. 8, 2006.

73. 31 C.F.R. § 10.34(b).

74. 31 C.F.R. § 10.34(c).

substantial understatement penalty regulations may be taken into account for purposes of this analysis. 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.⁷⁵

(2) *Frivolous*. A position is frivolous if it is patently improper.⁷⁶

F. Due Diligence

Section 10.22⁷⁷ requires all those who practice before the IRS to exercise “due diligence”:

- (1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to [IRS] matters;
- (2) In determining the correctness of oral or written representations made by the practitioner to the Department of Treasury; and
- (3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the [IRS].

As commentators have pointed out:

Even without adding anything to Circular 230, the requirement of exercising due diligence in determining the correctness of oral or written representations provided the Office of Professional Responsibility (OPR) a weapon for disciplining tax practitioners who went astray in the day-in, day-out work of the tax practitioner. We have worked with enough practitioners over the years, and reviewed enough tax files, to realize that the documentation of due diligence in determining the correctness of written representations is spotty at best, and is often nonexistent regarding oral advice.⁷⁸

Stephen A. Whitlock, deputy director of OPR, has said that the IRS is using section 10.22 as an “investigatory tool” against tax professionals.⁷⁹

Tax practitioners should be “reasonably knowledgeable” about reportable transactions.⁸⁰

75. 31 C.F.R. § 10.34(d)(1).

76. 31 C.F.R. § 10.34(d)(2).

77. 31 C.F.R. § 10.22(a)(1)-(3).

78. Burgess J.W. Raby & William L. Raby, *Confidence Levels, Circular 230, and Practitioner Penalties*, TAX NOTES TODAY, Jan. 15, 2005, available at LEXIS, Fedtax Library, 2005 TNT 3-24.

79. Kenneth A. Gray, *Internal Compliance A Priority For Firms, IRS Officials Warn*, TAX NOTES TODAY, January 25, 2005, available at LEXIS, Fedtax Library, 2005 TNT 3-24.

80. Burgess J.W. Raby & William L. Raby, *Practitioner “Due Diligence” and Listed Transactions*, TAX NOTES TODAY, Apr. 29, 2004, available at LEXIS, Fedtax Library, 2004 TNT 83-14.

The greatest problem for tax practitioners is not identification of the other reportable transactions, but concerns the listed transactions. The definitions of 'other' reportable transactions remain relatively constant. But the IRS can and does add to the listed-transaction category and deletes items from it without going through any regulatory process. It issues notices. [Notice 2004-67] provides the inventory of the listed transactions as of September 24, 2004 -- while the IRS Web site, under the caption 'Abusive Tax Shelters' in the corporations section, updates the roster of listed transactions and allows retrieval of the underlying documents. Practitioner due diligence seems to require accessing that information and the documents to which it cross-references, whenever relevant.⁸¹

G. Sanctions

The Treasury Department, after notice and an opportunity for a hearing,⁸² may censure, suspend,⁸³ or disbar any practitioner from practice before the IRS if the practitioner

- 1) "is shown to be incompetent or disreputable,"
- 2) *willfully* fails to comply with any of the practice regulations (other than the best practices in section 10.33),

81. Burgess J.W. Raby & William L. Raby, *JOBS Act Penalty Provisions and Tax Practitioners*, TAX NOTES TODAY, November 1, 2004, available at LEXIS, Fedtax Library, 2004 TNT 209-51. See *supra* notes 15-22 and accompanying text (describing the current listing of benefits-related listed transactions and the source documents describing each transaction).

82. The proposed regulations "redesignate the provisions relating to hearings, evidence and depositions and discovery. Proposed § 10.71 addresses discovery, proposed § 10.72 addresses hearings and proposed § 10.73 addresses evidence." Preamble to proposed regulations, 71 Fed. Reg. 6421, 6425, Feb. 8, 2006.

83. Preamble to proposed regulations, 71 Fed. Reg. 6421, 6427 (Feb. 8, 2006):

Section 10.82 of the regulations authorizes the Director of the Office of Professional Responsibility to suspend immediately a practitioner who has engaged in certain conduct. The proposed regulations extend the expedited process to practitioners who are in egregious noncompliance with their tax obligations or have been adjudicated as having advanced arguments, relating to the practitioner's own tax obligations or the obligations of the client, primarily for delay. The Treasury Department and the IRS are aware of a number of practitioners who are not in compliance with their own Federal tax obligations, but continue to represent taxpayers, and of situations in which practitioners advance frivolous or obstructionist positions relating to their own tax obligations and the obligations of their clients. Under the proposed regulations, a practitioner who is not compliant with the practitioner's own Federal tax obligations may be subject to expedited disciplinary proceedings. In addition, a practitioner who has been found by a court of competent jurisdiction to have advanced frivolous arguments or advanced arguments primarily for delay, either relating to a taxpayer's tax liability or relating to the practitioner's own tax liability, will be subject to an expedited disciplinary proceeding.

- 3) “recklessly or through gross incompetence” violates section 10.34, 10.35, 10.36 or 10.37,
 4) “or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client.”⁸⁴

The Jobs Act also authorizes monetary penalties against a practitioner who violates any provision of Circular 230.⁸⁵

The Declaration of Representative in the IRS Power of Attorney (Form 2848) includes a statement that, “I am aware of regulations contained in Treasury Department Circular No. 230 (31 CFR Part 10, as amended), concerning the practice of attorneys, certified public accountants, enrolled agents, enrolled actuaries, and others.”

Incompetence and disreputable conduct include “[g]iving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws.”⁸⁶

The Secretary may also disqualify an appraiser with respect to whom a penalty has been assessed under section 6701 of the Code.⁸⁷

IV. THE NEW CIRCULAR 230 REGULATIONS

On December 30, 2003, Treasury issued proposed regulations⁸⁸ and in December 2004, final regulations⁸⁹ that

84. 31 C.F.R. §§10.50, 10.52.

85. See Preamble to proposed regulations, 71 Fed. Reg. 6421, 6427 (Feb. 8, 2006).

86. 31 C.F.R. §10.51(1). See also Preamble to proposed regulations, 71 Fed. Reg. 6421, 6427 (Feb. 8, 2006).

Section 10.51 of the regulations defines disreputable conduct for which a practitioner may be sanctioned. Section 10.51 of the proposed regulations modifies the definition of disreputable conduct to include willful failure to sign a tax return prepared by the practitioner. The definition of disreputable conduct also includes the disclosure or use of returns or return information by practitioners in a manner not authorized by the Code, a court of competent jurisdiction, or an administrative law judge in a proceeding instituted under § 10.60.

Id.

87. 31 C.F.R. § 10.50(b).

88. 68 Fed. Reg. 75186. The preamble to the 2003 proposed regulations states that:

Tax advisors play an increasingly important role in the Federal tax system, which is founded on principles of voluntary compliance. The tax system is best served when the public has confidence in the honesty and integrity of the professionals providing tax advice. To restore, promote, and maintain the public's confidence in those individuals and firms, these proposed regulations set forth best practices applicable to all tax advisors. These regulations also amend the mandatory requirements for

significantly amended Circular 230. The 2004 regulations were revised by final regulations issued in May 2005,⁹⁰ and by additional proposed regulations that were issued in February 2006.⁹¹ The final regulations do not reflect changes made by the Jobs Act.

According to a news release issued by the IRS in connection with the February 2006, proposed regulations, “[e]nsuring that tax professionals adhere to professional standards and follow the law is one of the top four enforcement goals for the IRS. This proposed revision of Circular 230 plays a critical part in achieving this goal.”⁹² Despite being deluged with comments from practitioners, criticizing the breadth of the 2004 regulations,⁹³ the additional regulations issued in May 2005, made only modest changes and did not address the basic complaints.

Everything is a shelter, given the breadth of the definition of ‘tax avoidance transaction’ in section 10.35(b)(2)(B) and (C), and ‘significant federal tax issue’ in section 10.35(b)(3). ‘Put it this way: If it isn’t a significant federal tax issue that the IRS would care about, why is the client asking for expensive outside legal advice on it?’⁹⁴

A. Best Practices

Section 10.33 describes stringent best practices for all tax advisors (a term that is not defined) and all advice (another undefined term), including oral advice and other relatively

practitioners who provide certain tax shelter opinions. These regulations are limited to practice before the IRS and do not alter or supplant other ethical standards applicable to practitioners.

Id. at 75186-75187.

89. TD 9165, 69 Fed. Reg. 75839, Dec. 20, 2004. In December, 2004, Treasury also issued proposed regulations [69 Fed. Reg. 75887, Dec. 20, 2004] that, if finalized, will add a new section 10.39, covering tax advice relating to state and local bonds. These proposed regulations are not discussed further in this article.

90. 70 Fed. Reg. 28824, (May 19, 2005).

91. 71 Fed. Reg. 6421, (Feb. 8, 2006).

92. I.R.S. News Release 2006-22, (Feb. 3, 2006).

93. The preamble to the 2005 regulations states that:

Since publication of the Final Regulations, Treasury and the IRS have received a number of comments highlighting areas where the language of the Final Regulations might have consequences inconsistent with their intent. Upon consideration of those comments, the Treasury Department and the IRS have made revisions to the Final Regulations, as described below, to clarify the language of the Final Regulations.

70 Fed. Reg. 28824, 28824 (May 19, 2005).

94. Lee Sheppard, *Shelter Penalties: Or Else What? Part 3*, TAX NOTES TODAY, Feb. 15, 2005, available at LEXIS, Fedtax Library, 2005 TNT 30-5.

informal advice.⁹⁵ The “tax advisors” subject to these requirements are a broader class than practitioners, as defined in the regulations, and may also be a broader group than the classes of persons permitted to engage in “limited practice.”⁹⁶ One obvious question is whether the Treasury Department has the authority to issue regulations binding tax advisors who are not “practitioners” and, if so, what is the source of their authority.

These best practices are aspirational. A practitioner who fails to comply with best practices will not be subject to discipline.

These practices consist of:

(1) “Communicating clearly with the client regarding the terms of the engagement. . . ;”⁹⁷

(2) Establishing the relevant facts, including “evaluating the reasonableness of any assumptions or representations. . . ;”

(3) “[R]elating the applicable law (including potentially applicable judicial doctrines) to the relevant facts. . . ;”

(4) “[A]rriving at a conclusion supported by the law and the facts;

(5) “Advising the client regarding the import of the conclusions reached, including, for example, whether [the client] may avoid accuracy-related penalties under the [Code] if the [client] acts in reliance on the advice,” and

(6) “Acting fairly and with integrity in practice before the [IRS].”⁹⁸

This is a fairly high standard. For example, in many cases it will be difficult for tax advisors to be certain that they have identified all “potentially applicable” judicial doctrines. “Although best practices are solely aspirational, tax professionals are expected to observe these practices to preserve public confidence in

95. 31 C.F.R. §10.33 ; *see also Internal Compliance A Priority For Firms, IRS Officials Warn*, TAX NOTES TODAY, Jan. 25, 2005, available at LEXIS, Fedtax Library, 2005 TNT 15-4 (reporting that OPR Director Namorato has stressed that oral communications are also covered by Circular 230, but he admitted that the IRS would have a much harder time enforcing the rules on oral communications, because it is difficult to produce evidence of conversations).

96. William M. Paul et al., *The Final Regulations Under Circular 230*, TAX NOTES TODAY, Apr. 5, 2005, available at LEXIS, Fedtax Library, 2005 TNT 64-37. For the regulations governing limited practice, see 31 C.F.R. § 10.7 (c).

97. As the Academy Letter, *supra* note 54, notes:

These provisions seem subject to a broad range of interpretations. For example, one observer might describe a given instance of client interaction as reflecting very clear communication. Another might describe the same instance as reflecting a significant lack of communication. Especially with a subject as complex as taxes, it will often be impossible to demonstrate that one observer is right and the other wrong.

98. 31 C.F.R. § 10.33(a).

the tax system.”⁹⁹ Furthermore, failure to comply may in practice be used to support allegations of negligence or malpractice.

In addition:

Tax advisors with responsibility for overseeing a firm’s practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firm’s procedures for all members, associates, and employees are consistent with the best practices set forth in paragraph (a) of this section.¹⁰⁰

B. Covered Opinions

The most demanding and controversial provisions of the regulations deal with “covered opinions.”¹⁰¹ A practitioner (as defined above) who provides a covered opinion must comply with the standards of practice in 31 CFR section 10.35.

1. What is a “Covered Opinion”?

A covered opinion is *written* advice (including e-mail or other electronic communications - does this include text messages on a cell phone?) by a practitioner that concerns one or more Federal tax issue(s) arising from a listed transaction, or a “principal purpose” transaction or, subject to exceptions, a “significant purpose” transaction.¹⁰²

a. Listed Transactions

A “Listed Transaction” is one that is the same as, or substantially similar to, a transaction that, at the time the advice is rendered, the Service has determined to be a tax avoidance transaction and identified by published guidance as a listed transaction under 26 C.F.R. section 1.6011-4(b)(2). The current list of listed transactions is set out in Notice 2004-67.¹⁰³ All written advice regarding a listed transaction is a covered opinion: a practitioner (1) may not avoid the covered opinion requirements by including a “not for penalty protection” statement and (2) may never give a limited scope opinion with respect to a listed transaction.

99. Regulations Governing Practice Before the Internal Revenue Service, 69 Fed. Reg. 75839, 75840 (Dec. 20, 2004) (to be codified 31 C.F.R. pt. 10).

100. 31 C.F.R. § 10.33(b) [emphasis added].

101. The 2003 proposed regulations used the term “tax shelter opinion”, which is replaced in the December, 2004 final regulations by “covered opinion.” Regulations Governing Practice Before the Internal Revenue Service, 69 Fed. Reg. 75839, 75840 (Dec. 20, 2004)

102. 31 C.F.R. § 10.35(b)(2)(A)-(C).

103. I.R.S. Notice 2004-67, 2004-2 C.B. 600. See *supra* text accompanying notes 15-22.

Currently, the IRS has identified seven transactions involving employee benefit plans as listed transactions: see Section II. B. above.¹⁰⁴ For example, assume that client sends Pension Maven an e-mail asking: Can I adopt a 412(i) plan, funded with a \$5 million whole life insurance policy, without encountering problems from the IRS? It seems that Pension Maven may not simply send an e-mail reply that says: No. IRS has identified such a 412(i) plan as a listed transaction. As the NYSBA Report correctly states, “[w]ithout such written advice from practitioners, clients may make uninformed decisions to engage in abusive transactions.”¹⁰⁵

The list of transactions is updated frequently, generally in the form of a Notice or other relatively informal guidance, so practitioners must keep up with developments in this area. Also, the boundaries of some of these transactions are unclear. Is advice as to whether a proposed transaction is a listed transaction a covered opinion in this category?

b. Principal Purpose Transactions

A “principal purpose transaction” is any plan or arrangement, the principal purpose of which is the avoidance or evasion of any federal tax. A practitioner (1) may not avoid the covered opinion requirements by including a “not for penalty protection” statement; and (2) may never give a limited scope opinion with respect to a principal purpose transaction.

c. Significant Purpose Transactions

A “significant purpose transaction” is any plan or arrangement, a significant purpose of which is the avoidance or evasion of any federal tax if the written advice –

- 1) “Is a reliance opinion,”
- 2) “Is a marketed opinion,”
- 3) “Is subject to conditions of confidentiality” (e.g., the practitioner imposes a limitation on disclosure of the tax treatment or tax structure of the transaction);¹⁰⁶ or

104. See I.R.S. Notice 2004-67, 2004-2 C.B. 600; 31 C.F.R. 10.35(b)(2)(A)-(C); Abusive Tax Transactions, *supra* note 15.

105. NYSBA REPORT, *supra* note 52, at 29.

106. 31 C.F.R. §10.35(b)(6) provides:

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

4) “Is subject to contractual protection” (e.g., the taxpayer has the right to a refund of fees if intended tax consequences are not sustained).¹⁰⁷

In a speech on September 30, 2005, IRS Chief Counsel Donald Korb said that the IRS wanted to find a way to exclude routine advice from the covered opinion rules, but it proved too difficult.¹⁰⁸

2. Advice That Is Not a “Covered Opinion”

Written advice regarding a significant purpose transaction (as opposed to a listed transaction or principal purpose transaction) is excluded from the definition of a covered opinion if the written advice concerns the qualification of a qualified plan,¹⁰⁹ is a State or local bond opinion,¹¹⁰ or is included in documents required to be filed with the SEC.¹¹¹ The “qualified plan exception” is discussed further below.¹¹²

The term “covered opinion” also does not include:

(A) “Written advice provided to a client during the course of an engagement if a practitioner is reasonably expected to provide subsequent written advice to the client that satisfies” the covered opinion requirements.¹¹³ However, in many, if not most, cases of informal advice, there is no expectation, let alone a reasonable expectation, of a formal opinion. In many cases, the client does not want or need, and is not willing to pay for, an opinion that satisfies the requirements.¹¹⁴

107. 31 C.F.R. §10.35(b)(7) provides:

Written advice is subject to contractual protection if the taxpayer has the right to a full or partial refund of fees if all or a part of the intended tax consequences are not sustained, or if the fees are contingent on the taxpayer’s realization of tax benefits from the transaction. All the facts and circumstances will be considered when determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties have not designated as fees or any agreement to provide services without reasonable compensation.

108. Crystal Tandon, *Korb Responds to Lawyers’ Circular 230 Hypotheticals*, TAX NOTES TODAY, Oct. 3, 2005, available at LEXIS, Fedtax Library, 2005 TNT 190-5.

109. 31 C.F.R. § 10.35(c)(2).

110. See 31 C.F.R. § 10.35(b)(9) (defining state and local bond opinion).

111. 31 C.F.R. § 10.35(b)(2)(ii)(B).

112. See *infra* Section V.B.

113. 31 C.F.R. § 10.35(b)(2)(ii)(A).

114. See NYSBA REPORT, *supra* note 52, at 16:

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

(B) “Written advice prepared for and provided to a taxpayer, solely for use by that taxpayer, after the taxpayer has filed a tax return with the [Service] reflecting the tax benefits of the transaction.”¹¹⁵ However, “[t]he preceding sentence does not apply if the practitioner knows or has reason to know that the written advice will be relied upon by the taxpayer to take a position on a tax return” (including an amended return) filed after the date on which the advice is provided.¹¹⁶

(C) Written advice provided to an employer by a practitioner as an employee of that employer, “solely for purposes of determining the tax liability of the employer,”¹¹⁷ or

(D) “Written advice that does not resolve a Federal tax issue in the taxpayer’s favor, unless the advice reaches a conclusion favorable to the taxpayer at *any* confidence level (e.g., not frivolous, realistic possibility of success, reasonable basis or substantial authority) with respect to that issue.”¹¹⁸

Government officials have confirmed that this exception is intended to be very narrow. It is meant to cover only advice that unequivocally tells a client not to engage in a transaction. If a practitioner analyzes or evaluates the possibilities of success, then the opinion will be subject to the covered opinion rules. This may create a conflict with state bar ethics rules. If a lawyer believes that a transaction has a reasonable possibility of surviving a challenge, the lawyer cannot ethically just say no. The client is entitled to an opinion that provides an adequate basis for the client – not the lawyer – to make the decision whether to proceed.¹¹⁹

Written advice that is not a covered opinion for purposes of section 10.35 is subject to the standards for other written advice, set forth in the new section 10.37.¹²⁰

3. What Is A “Reliance Opinion”?

A reliance opinion is written advice that concludes, at a confidence level of at least more likely than not, that one or more significant Federal tax issues would be resolved in the taxpayer’s favor.¹²¹ Opinions at the “substantial authority” level are not reliance opinions, and thus are subject to the standards for “other

proceeding on the basis of advice that has not been exhaustively researched and examined.

115. 31 C.F.R. § 10.35(b)(2)(ii)(C).

116. *Id.*

117. 31 C.F.R. § 10.35(b)(2)(ii)(D).

118. 31 C.F.R. § 10.35(b)(2)(ii)(E) (emphasis added).

119. Government Officials Take On Tax Bar Over Circular 230 Changes, TAX NOTES TODAY, May 24, 2005, available at LEXIS, Fedtax Library, 2005 TNT 99-5.

120. 31 C.F.R. § 10.35(f). See *infra* Part IV.D.

121. 31 C.F.R. § 10.35(b)(4).

written advice,” not the more demanding requirements for covered opinions, unless some other factor brings them within the covered opinion definition (e.g., conditions of confidentiality).¹²²

A federal tax issue is a question concerning the federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for federal tax purposes.¹²³ This seems to include most retirement planning transactions.

A federal tax issue is significant if the IRS has a reasonable basis for a successful challenge and its resolution could have a “significant impact,” whether beneficial or adverse and under any reasonably foreseeable circumstances, on the overall federal tax treatment of the transactions or matters addressed in the opinion.¹²⁴ This is a lower threshold than “realistic possibility of success.” The regulations do not define the term “significant impact,” which does not appear anywhere else in the Code or the regulations.¹²⁵

Written advice (other than advice concerning a listed transaction or a principal purpose transaction) will not be treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and cannot be used by the taxpayer, for the purpose of avoiding penalties.¹²⁶

4. What Is A “Marketed Opinion”?

Written advice is a marketed opinion if the practitioner knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner’s firm) in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayers.¹²⁷

Written advice (other than advice concerning a listed transaction or a principal purpose transaction) is not treated as a marketed opinion if the practitioner prominently discloses in the written advice that:

- (A) [t]he advice was not intended or written by the practitioner to be used, and that it cannot be used by any taxpayer, for the purpose

122. Carolyn H. Grey, *Tax Analysts Obtains IRS OPR Outline for Circular 230 Practitioner Phone Forum*, TAX NOTES TODAY, June 23, 2005, available at LEXIS, Fedtax Library, 2005 TNT 120-20.

123. 31 C.F.R. § 10.35(b)(3).

124. *Id.*

125. Natalie B. Choate, *How I Will Comply With Circular 230*, TRUSTS & ESTATES, July 2005, at 26.

126. 31 C.F.R. § 10.35(b)(4)(ii).

127. 31 C.F.R. § 10.35(b)(5)(i).

of avoiding penalties that may be imposed on the taxpayer;

(B) [t]he advice was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice;

(C) the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.¹²⁸

Written advice that would otherwise constitute a marketed opinion, but satisfies these three requirements, is subject to a "heightened standard of care" under Section 10.37 because of the "greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances."¹²⁹ The fact that the IRS has no reasonable basis to challenge the advice does not eliminate the advice from the marketed opinion category. Unlike reliance opinions, there is no requirement that a marketed opinion provide advice regarding a "significant" tax issue.

The NYSBA Report comments that this definition includes many forms of written advice that are not used to market tax shelters.¹³⁰ It could include, for instance, a brochure about IRAs, an article about federal pension issues, an outline distributed at a seminar sponsored by someone other than the practitioner (or his or her firm) attended by other tax practitioners, or answers posted on a practitioners' listserv.¹³¹ This is true even if the client uses the materials without attribution to the practitioner, because 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."¹³²

During a May 10, 2005 webcast, a participant asked whether such a handout would be covered by the rules. Cono Namorato, director of OPR, dismissed the issue: "[n]o more than would a practitioner's Valentine's Day card to his spouse." Those materials fit literally within the rules' definition of a covered opinion: why did the regulations not exclude them?¹³³

128. 31 C.R.F. § 10.35(b)(5)(ii).

129. 31 C.F.R. § 10.37(a).

130. NYSBA REPORT, *supra* note 52, at 18.

131. Jonathan G. Blattmachr, et al., *The Application of Circular 230 in Estate Planning*, TAX NOTES TODAY, Apr. 5, 2005, available at LEXIS, Fedtax Library, 2005 TNT 64-36. "In each case, the practitioner knows that the client will use the brochure in promotion and, because some tax issue no doubt will be discussed, each presumably must contain the three prominently disclosed written warnings." *Id.*

132. Comments of the American Bar Association, Section of Real Property, Probate, and Trust Law, reprinted as Edward F. Koren, *ABA Section Members Comments On Circular 230 Regs*, TAX NOTES TODAY, May 11, 2005, available at LEXIS, Fedtax Library, 2005 TNT 90-23.

133. Sheryl Stratton, *Common Sense Urged by I.R.S. at Circular 230 Program*, TAX NOTES TODAY, 2005 TNT 90-3; Sheryl Stratton, *Circular 230*

According to a September 2005 speech by Michael J. Desmond, acting tax legislative counsel for legislative affairs, the definition of marketed opinion is "Circular 230's biggest pressure point." He reiterated that articles, outlines, and speeches are not marketed opinions because they do not constitute advice rendered to a client. Practitioners have requested confirmation that this is the IRS's position.¹³⁴ One suggestion is to limit the definition of "advice" to "writings prepared for the benefit of a practitioner's client, whether or not the client is the taxpayer whose tax treatment is addressed."¹³⁵

5. "Significant Purpose" and "Principal Purpose"

It may be difficult, if not impossible, for an advisor to determine whether a transaction has a "significant" purpose of tax avoidance or tax evasion, or whether that is the principal purpose. The tax shelter regulations provide that a purpose is "the principal purpose" if it "exceeds any other purpose."¹³⁶ This is not very helpful.

According to the Internal Revenue Manual, "one who avoids tax does not conceal or misrepresent. He shapes events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure."¹³⁷ Under this definition, any transaction that results in a reduction of tax liability could be viewed as having at least a "significant" purpose of tax avoidance. As the NYSBA Report says:

The Not For Penalty Protection Banner will not remove written advice regarding a Principal Purpose Transaction from the category of a covered opinion. Further, Limited Scope Opinions are prohibited with respect to a Principal Purpose Transaction. As a result, under the December Regulations, any written advice, regardless of its purpose or use, that concerns a Principal Purpose Transaction, must be given in the form of a full-blown opinion that satisfies all of the covered opinion standards. The absence of an opt-out for advice concerning Principal Purpose Transactions creates a blanket prohibition against any short-form written advice with respect to such transactions.¹³⁸

Changes Fall Short of Expectations, TAX NOTES TODAY, June 7, 2005, available at LEXIS, Fedtax Library, 2005 TNT 108-2.

134. Sheryl Stratton, *Fixing Circular 230 Rules Remains High Priority*, Treasury Says, TAX NOTES TODAY, Sept. 19, 2005, available at LEXIS, Fedtax Library, 2005 TNT 180-2; Crystal Tandon, *Practitioners Demanding Clear Outlines of Circular 230's Scope*, TAX NOTES TODAY, Aug. 29, 2005, at 977.

135. Michael L. Schler et al., *Attorneys Seek Circ. 230 Revisions To Address Practical Problems*, 109 TAX NOTES TODAY 836, 839 (Nov. 7, 2005).

136. Treas. Reg. § 1.6662-4(g)(2)(i)(C).

137. Internal Revenue Manual § 9.1.3.3.2.1 (1998).

138. NYSBA REPORT, *supra* note 52, at 24.

Under the May, 2005, revisions to the final regulations:

The principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is not to avoid or evade Federal tax if that partnership, entity, plan or arrangement has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose. A partnership, entity, plan or arrangement may have a significant purpose of avoidance or evasion even though it does not have the principal purpose of avoidance or evasion under this paragraph (b)(10).¹³⁹

Compare this language to the language in the *Sargent* case: "The Code provisions relating to qualified retirement plans are a deliberate congressional bestowal of benefits upon employers and employees; efforts to obtain the advantages of these benefits . . . are not to be deemed to render the taxpayer culpable of illegal tax avoidance or evasion."¹⁴⁰

While somewhat helpful, this clarification of the regulations does not get us very far. When does an arrangement have as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose? A non-controversial application of the rules (e.g., advising a client to use an integrated allocation formula under Code section 401(l)) is clearly not a principal purpose transaction under this test; but it could still be a significant purpose transaction.¹⁴¹ And it is not clear that the new language applies at all where it is most needed, for example, to more controversial plan designs such as a cash balance plan with wearaway or an aggressively cross-tested defined contribution plan. One comment letter to the IRS, somewhat optimistically, sought:

confirmation that the establishment or maintenance of a qualified retirement plan is never a transaction, "the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code (IRC)." . . . We believe that if, in general, the principal purpose of a qualified plan is not tax avoidance or evasion, then the principal purpose of any qualified plan is not tax avoidance or evasion. We seek guidance as to whether you agree, and if not, that criteria should be used to differentiate.¹⁴²

139. 31 C.F.R. § 10.35(b)(10).

140. *Sargent v. Comm'r.*, 929 F.2d 1252, 1260 (8th Cir., 1991) (citing *Keller v. Comm'r.*, 77 T.C. 1014, 1030 (1981)).

141. See IRS Chief Couns. Adv. Mem. 200513022, (Nov. 15, 2004) ("The term 'significant purpose' is not defined in Code Section 6662. In addition, the regulations pursuant to Code Section 6662 do not address the meaning of 'significant purpose' because they have not been updated since the test was changed from 'principal purpose' to 'significant purpose' for transactions entered into after August 5, 1997").

142. Academy Letter, *supra* note 54; see also Michael Macris, et al., *Attorneys Suggest Changes To Circular 230 Regs Relating To Employee*

6. Requirements for Covered Opinions

A practitioner who provides a covered opinion must comply with each of the following requirements. For this purpose, a “practitioner” includes any individual described in section 10.2(e).¹⁴³

The practitioner must:¹⁴⁴

(1) Use reasonable efforts to identify and consider all relevant facts and not rely on any unreasonable factual assumptions or representations. An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or incomplete. The Academy Letter requested ‘guidance to clarify that the data used for actuarial valuations would not be subject to the prohibition of unreasonable factual assumptions, as long as the data satisfies applicable actuarial standards.’¹⁴⁵ For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. The opinion must identify in separate sections (i) all factual assumptions relied upon by the practitioner and (ii) all factual representations, statements or findings of the taxpayer relied upon by the practitioner.

(2) Relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts and not rely on any unreasonable legal assumptions, representations or conclusions. The judicial doctrines would include, at least, the sham transaction doctrine, the substance over form doctrine, the business purpose doctrine, the economic substance doctrine, the step transaction doctrine, and the reciprocal trust or reciprocal transfer doctrine. These court-developed doctrines are uncertain in scope and content.¹⁴⁶ It is not clear whether the opinion must consider and discuss the facts and law relevant to all federal tax issues or only those relevant to significant federal tax issues. The opinion may not contain internally inconsistent legal analyses or conclusions.¹⁴⁷

Benefits, Compensation, TAX NOTES TODAY, Oct. 11, 2005, available at LEXIS, Fedtax Library, 2005 TNT 195-47.

143. 31 C.F.R. §§ 10.35(a), (b)(1). See *supra* Part III.B.

144. 31 C.F.R. § 10.35(c).

145. Academy Letter, *supra* note 54.

146.

Unfortunately, those judicial or court-developed doctrines are not codified and therefore are uncertain in scope and content. It seems, to be on the “safe” side, that each covered opinion should discuss each doctrine. For example, although it does not seem that the business purpose doctrine is generally applicable to steps taken to reduce gift tax, a discussion that the doctrine should not apply (and specifying why that is so) probably should be contained in the advice.

Blattmachr, *supra* note 131.

147.

This limitation has been criticized: Taxpayers should be permitted to obtain from practitioners a complete analysis of a given tax issue. In

(3) Consider all significant federal tax issues¹⁴⁸ and reach a conclusion, supported by the facts and the law, as to the likelihood that the taxpayer will prevail on the merits with respect to each such issue. If the practitioner is unable to reach a conclusion with respect to one or more issues, the opinion must so state. The opinion must describe the reasons for the conclusions, including the facts and analysis supporting the conclusions, or describe the reasons that the practitioner is unable to reach a conclusion. If the practitioner fails to reach a conclusion, at a confidence level of at least more likely than not, with respect to one or more significant Federal tax issues considered, the opinion must include the disclosure(s) required under section 10.35(e). 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.

(4) Provide an overall conclusion as to the likelihood that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion.

The practitioner must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion, except that the practitioner may rely on the opinion of another practitioner with respect to one or more significant Federal tax issues, unless the practitioner knows or should know that the opinion of the other practitioner should not be relied on. If a practitioner relies on the opinion of another practitioner, the relying practitioner's opinion must identify the other opinion and set forth the conclusions reached in the other opinion. The practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion, if any, satisfy the requirements of section 10.35.¹⁴⁹

There are additional required disclosures (i) for marketed opinions, limited scope opinions and opinions that fail to reach a

some situations, the state of the law is so complex that it may be appropriate for written advice to discuss alternative theories or conclusions. Such discussions should not be prohibited as long as at least one analysis or conclusion supporting the taxpayer's position satisfies the requirements of Section 10.35.

NYSBA REPORT, *supra* note 52, at 36.

148. "A Federal tax issue is a question concerning the Federal tax treatment 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." 31 C.F.R. § 10.35(b)(3). A federal tax issue is significant if the IRS has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall federal tax treatment of the transaction(s) or matter(s) addressed in the opinion. This is a lower threshold than "realistic possibility of success."

149. 31 C.F.R. § 10.35(d).

more likely than not conclusion and (ii) if there is a relationship between the practitioner and a promoter.¹⁵⁰ Written advice that is not a covered opinion for purposes of section 10.35 is subject to the standards set forth in the new section 10.37.¹⁵¹

According to the NYSBA Report:

The regulations constrain all written tax advice. While their target is the tax shelter advice described above, most written tax advice does not fit that model. Taxpayers seek tax advice in a variety of circumstances, generally to understand and comply with the tax law, rather than to skirt it. By burdening all written tax advice, the December Regulations make desirable advice more difficult for taxpayers to receive. The December Regulations thus interfere with voluntary compliance. . . .

The elaborate requirements applicable to covered opinions are impractical in the context of the informal advice that practitioners often provide to clients. As a result, those requirements will impede taxpayers from receiving quick informal advice that they require. Such an impediment is undesirable from a tax policy perspective, because quick informal advice facilitates taxpayers' knowledge of and compliance with the tax law. Such advice allows taxpayers to make informed decisions on a 'real time' basis¹⁵²

We believe that informal e-mails are more akin to oral advice than they are to formal tax opinions. In order to continue to permit taxpayers to receive quick informal tax advice that enhances their understanding of the tax law and ability to comply, we believe that informal advice, such as most e-mails, should be excluded from the concept of 'covered opinion.'¹⁵³

7. Limited Scope Opinions¹⁵⁴

The practitioner may provide an opinion that does not consider all of the significant Federal tax issues (a "limited scope opinion") if:

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

(2) The opinion is not advice concerning a listed transaction or a principal purpose transaction, or a marketed opinion; and

(3) "The opinion includes the appropriate disclosure(s) required under [section 10.35(e)]."

150. 31 C.F.R. § 10.35(e).

151. 31 C.F.R. § 10.35(f).

152. NYSBA REPORT, *supra* note 52.

153. NYSBA REPORT, *supra* note 52, at 2, 12.

154. 31 C.F.R. § 10.35(c)(3)(v).

“A practitioner may make reasonable assumptions regarding the favorable resolution of a Federal tax issue (an assumed issue) for purposes of providing” a limited scope opinion. “The opinion must identify in a separate section all issues for which the practitioner assumed a favorable resolution.”¹⁵⁵

C. Firm Procedures

Practitioners with responsibility for overseeing a firm’s tax practice must take “reasonable steps” to ensure that the firm’s procedures for all members, associates, and employees are consistent with the best practices described in section 10.33.¹⁵⁶ This provision is aspirational. In addition, a practitioner with this oversight responsibility must take “reasonable steps” to ensure that the firm has “adequate procedures” in effect for purposes of complying with the section 10.35 requirements for covered opinions.¹⁵⁷ The individuals to be covered by these procedures include people who are not themselves “practitioners.” What are adequate procedures? Safe harbors would help greatly. The regulations do not specifically require the procedures to be in writing, but IRS officials have advised practitioners to put them in writing.¹⁵⁸

D. Requirements for Other Written Advice

The final regulations also set forth requirements for written advice that is not a covered opinion, but addresses any federal tax issue, whether “significant” or not.¹⁵⁹ A practitioner must not give written advice if the practitioner:

- (1) “bases the written advice on unreasonable factual or legal assumptions”;
- (2) “unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person”;
- (3) fails to “consider all relevant facts that the practitioner knows or should know”; or
- (4) “takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit”, or that an issue will be settled.

Section 10.37, unlike section 10.35, does not require that the practitioner describe in the written advice the relevant facts (including assumptions and representations), the application of

155. 31 C.F.R. § 10.35(c)(3)(B).

156. 31 C.F.R. § 10.33(b).

157. 31 C.F.R. § 10.36.

158. Heather Bennett & Kenneth A. Gary, *Namorato: OPR To Keep Careful Watch on Standards of Practice*, TAX NOTES, Jan. 31, 2005, at 523.

159. 31 C.F.R. § 10.37.

the law to those facts, or the practitioner's conclusion with respect to the law and the facts.

All facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client, will be considered in determining whether a practitioner has failed to comply with the requirements of section 10.37.

In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Code, the determination of whether a practitioner has failed to comply with this section will be made on the basis of a heightened standard of care because of the greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.

The NYSBA Report points out that the prior regulations¹⁶⁰ already policed the general conduct of practitioners by giving the Treasury Department the authority to sanction any practitioner who is shown to be disreputable or incompetent. Thus, the Report suggests that "[t]he more specific rules set forth in Section 10.37 are not necessary" and states that

[w]e believe that Section 10.37 would deter practitioners from giving written tax advice that is helpful to the proper functioning of the tax system. We are not aware of any other context in which a professional's written advice to a client is so closely regulated.¹⁶¹

A tax practitioner is subject to sanction if he or she willfully, recklessly or through gross incompetence violates section 10.37.¹⁶²

E. Effective Dates

The standards for covered opinions under section 10.35, and the standards for other written advice under section 10.37, are applicable to written advice that is rendered after June 20, 2005. The procedures to ensure compliance under section 10.36 are applicable after June 20, 2005.¹⁶³

160. 31 C.F.R. § 10.50.

161. NYSBA REPORT, *supra* note 52, at 38.

162. 31 C.F.R. § 10.52(a)(2).

163. 31 C.F.R. §§ 10.35(g), 10.36(b), 10.37(b).

V. WHICH ACTIVITIES OF EMPLOYEE BENEFITS PROFESSIONALS ARE SUBJECT TO THE REGULATIONS?

A. *In General*

Individual activities of a benefits professional may not be subject to the covered opinion requirements, for several reasons. For example:

[T]he activity does not constitute giving advice, e.g. a third party administrator (TPA) sends to a client a quarterly allocation report for a 401(k) plan.

There is no written advice: an actuary has a telephone conversation with a client about deduction limitations for a defined benefit plan. This may, however, be subject to the best practices rules, and any follow up communication (for example, an e-mail) could be written advice.

The advice does not concern a federal tax issue, e.g. an attorney advises a client on the fiduciary responsibility rules under Title I of the Employee Retirement Income Security Act of 1974 (ERISA).¹⁶⁴

The advice does concern a federal tax issue, but does not relate to a listed transaction, a principal purpose transaction or a significant purpose transaction.

The advice concerns a significant purpose transaction, but is not a reliance opinion or a marketed opinion, and is not subject to conditions of confidentiality or contractual protection; or is within the qualified plan exception; or is within one of the other exceptions listed in section IV. B. 2 above, "Advice That Is Not A 'Covered Opinion'".

Even if the advice is not a covered opinion, it must satisfy the requirements for other written advice. These requirements would not apply if:

- (1) there is no advice;
- (2) the advice is not written; or
- (3) the advice does not address any federal tax issue (significant or otherwise).

B. *The Scope of the Qualified Plan Exception*

The qualified plan exception appears to be narrower than the prior exclusion of annuities, qualified plans, and IRAs from the definition of "tax shelter." In addition, it is available only for

164. Employee Retirement Income Security Act of 1974, Pub. L. 93-406, 88 Stat 829 (codified as amended in scattered sections of Titles 26 and 29 of the U.S. Code)

advice concerning a significant purpose transaction, not for advice concerning a listed transaction or a principal purpose transaction.

In a September 27, 2005 letter to Namorato, a group of attorneys requested that

you confirm that it is reasonable to interpret the exception in Section 10.35(b)(2)(ii)(B)(1) of Circular 230 for advice that “concerns the qualification of a qualified plan” (the “Qualified Plan Exception”) to encompass (i) all plans that provide retirement benefits on a tax-favored basis and (ii) all advice provided to entities and individuals (such as plan sponsors, plan fiduciaries, third party recordkeepers, actuaries and other persons acting in their capacities as third party service providers to a particular plan, plan participants, and individual retirement account (“IRA”) depositors and their advisors) relating to the selection, implementation, administration, design and proper operation of such plans. To the extent the language of the regulations does not permit such an interpretation, we respectfully request that the regulations be amended to provide for such an interpretation.¹⁶⁵

They also suggested that the exception be broadly interpreted to cover advice concerning welfare plans, tax disclosures relating to equity compensation, and advice relating to taxes other than income tax.

Advice that is outside of the scope of tax advice should therefore include, at a minimum, advice regarding taxes and penalties for failure to satisfy minimum funding requirements under Code Section 4971, for making excess and nondeductible contributions under Code Sections 4972, 4973 and 4979, for failure to send out a “204(h)” notice under Code Section 4980F, for failure to satisfy continuing health coverage requirements under Code Section 4980B, and for advice relating to the “prohibited transaction” excise taxes under Code Section 4975.¹⁶⁶

From remarks made by IRS and Treasury personnel at conferences,¹⁶⁷ it is clear that their interpretation of the scope of the exception is much narrower than that requested by the attorneys. However, it is very difficult to delineate, with any confidence, what is and is not within its scope.

It appears that the qualified plan exception applies to advice regarding the qualification of a plan that the practitioner believes to be qualified, even if it is later determined that the plan was not qualified.¹⁶⁸

165. Macris, *supra* note 142

166. *Id.*

167. See, e.g., Sheila R. Cherry, *Treasury Officials List Document Exemptions Under Final Circular 230 Regulations*, BNA PENSION & BENEFITS DAILY, Aug. 17, 2005.

168. See generally Academy Letter, *supra* note 54.

In many cases, the availability of the exception may depend, at least partly, on the context. For example, does the communication relate to a proposed plan design or to the administration of a plan that has already been adopted? The Academy Letter¹⁶⁹ suggests, somewhat optimistically, that the exception covers written communications about:

(1) the rules governing the extent to which the use of insurance company contracts and various other investments will adversely affect a plan's qualified status;

(2) the rules governing the extent to which honoring a domestic relations order will adversely affect a plan's qualified status;

(3) the rules respecting benefit distributions and rollovers that must be followed in order to avoid adversely affecting a plan's qualified status;

(4) nondiscrimination testing under Internal Revenue Code sections 410(b) and 401(a)(4);

(5) any rule whose incorrect application would cause an otherwise qualified plan to lose its qualified status; and

(6) other written results and advice that pension actuaries often provide in the normal course of their activities. "Often, this information has nothing to do with conclusions regarding a plan's qualification status. Rather, this information is typically related to maintaining a plan's compliance with ERISA and various tax-related laws," such as:

(a) the rules for calculating minimum funding requirements, maximum deductible contributions, section 415 limits with respect to the individual participant, section 417(e) minimum lump sums, the top 25 restricted distributions, and section 420 asset transfers;

(b) The rules for calculating excise taxes and similar miscellaneous taxes incidental to the establishment, administration, and termination of qualified plans;

(c) the rules for determining the extent to which plan participant loans are taxable as current distributions;

(d) the tax rules related to group life insurance, uninsured health plans, cafeteria plans, fringe benefit arrangements, dependent care plans, cash or deferred arrangements embedded in qualified plans, non-qualified deferred benefits, VEBAs, ESOP loans, and other compensation and benefits issues;

(e) the rules for determining whether distributions constitute a series of substantially equal payments for the purposes of Code Sec. 72(q) and similar sections; and

(f) the timing and content rules of reporting and disclosure requirements related to qualified plans and other employee benefit plans.

169. *Id.*

The Academy Letter¹⁷⁰ also says that

a pension actuary's responsibility is not to render opinions respecting application of tax laws. Instead, it is to make those calculations that must be made in order to apply these laws. For this reason, if for no other, we do not believe performing computations related to any item on our lists—and communicating, in writing, the results of these computations—constitutes the rendering of a covered opinion.

Similarly, the Academy Letter points out that:

[A]n enrolled actuary's authorization to practice before the IRS is limited to well-defined sections of Title 26 of the United States Code. Many of the activities we have listed fall outside this well-defined authorization. We do not believe that computations and their written communication involving issues falling outside this area of authorization constitute covered opinions.¹⁷¹

Enrolled actuaries are clearly subject to regulation by the Treasury Department and the IRS. If, without complying with the regulations, they engage in activities that (1) are outside the scope of their authority to practice, but (2) are covered by the regulations, then to say that it is not their "responsibility," or that it is outside their area of authorization is not a convincing defense.

During an August 16, 2005, teleconference sponsored by the American Bar Association Joint Committee on Employee Benefits, W. Thomas Reeder, acting benefits tax counsel, said that the rules were not intended to apply to routine types of documents that would generally not be considered advice and where no further analysis is necessary.¹⁷² Speaking on his own behalf, he noted that such documents would include:

A summary plan description (SPD) of a qualified plan covered by ERISA, or a summary of a nonqualified plan,

the distribution of prospectuses;

plan enrollment and open season materials,

information on investment choices, and benefit calculators and portfolio allocation tools,

notices of requests for determination letters,

newsletters,

comments submitted to Congress or regulatory officials, and

170. *Id.*

171. *Id.*

172. Cherry, *supra* note 167.

articles in tax journals or conference materials.

Michael J. Desmond, acting tax legislative counsel for legislative affairs, said that the last thing officials would want to do is discourage clear communications between practitioners and consumers.¹⁷³ If a communication does constitute advice (i.e., it does not fall under one of the categories of documents noted above) it would only constitute advice under Circular 230 if it addressed a federal tax issue. Advice concerning such issues as anything under Title I or IV of ERISA or, generally, excise tax matters arising under either the prohibited transaction rules or the COBRA continuation of health care coverage rules would be exempt because those issues are not federal tax issues, as defined by Circular 230.¹⁷⁴

Reeder also said that certain prohibited transaction rules involving IRAs may be federal tax issues, since the sanctions do not involve excise taxes.¹⁷⁵ Excluded advice would include written documents involving the qualification of employer plans under section 401(a). He stressed that, while he would like to exclude advice with respect to other employer-provided plans (e.g., sections 403(a), 403(b), and 457), it would be imprudent to presume they are exempt. Nor would IRAs be exempt under that provision.¹⁷⁶

VI. CONCLUSION

Government officials have stated repeatedly that the final regulations were designed to intrude as little as possible on practitioners' daily work and the attorney-client relationship:

These revisions to Circular 230 strike an appropriate balance between tightening practitioner standards and minimizing burden on everyday advice. These rules target the types of written advice that present a significant cause for concern and avoid undue interference with the practitioner-client relationship.¹⁷⁷

However, contrary to the stated intent, the regulations (particularly sections 10.35 and 10.37) could affect almost everything a benefits practitioner does, except oral advice.¹⁷⁸ There is hardly any case law under Circular 230 to guide practitioners. Stephen Whitlock, Deputy Director of the OPR has stated, "[c]learly, there's a need for the IRS to provide something other than Circular 230 to guide practitioners. There is no body of

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. I.R.S. and the Treasury Department Amend Circular 230 to Promote Ethical Practice by Tax Professionals, IR-2004-152, Dec. 17, 2004 (quoting Acting Assistant Secretary for Tax Policy Greg Jenner).

178. *See supra* note 52, at 2, 12.

case law under Circular 230, and there is quite a ways to go to give practitioners a better comfort level around the issues.¹⁷⁹

According to Namorato, OPR will consider the facts and circumstances giving rise to the advice in applying the section 10.35 requirements for written advice: "An off-the-cuff response" in a one-line e-mail is not the kind of advice the OPR is interested in.¹⁸⁰

During the teleconference on August 16, 2005, Desmond said that additional guidance will be issued soon. The new guidance will aim to "better focus" the rules and will be issued within "months, not years."¹⁸¹ However, according to a speech by Desmond in September, 2005:

[T]here is a view that the problems should be addressed on a more deliberate basis, so as to avoid having to revise them every three months. While fixing the rules is a high priority, there is also some desire to 'let the dust settle'. Adding exceptions and definitions is 'not the way to go.'¹⁸²

According to a recent speech by Stephen Whitlock, deputy director of OPR, the IRS is hoping to release soon a new round of proposed amendments to the regulations, addressing covered opinion standards, contingent fees and disclosure rules.¹⁸³ However, in an even more recent speech, he said that the new rules are not "onerous changes from what competent professionals should have been doing all along."¹⁸⁴

As the NYSBA Tax Section has pointed out:

Senior Treasury officials have been reported in the press to have stated that the December Regulations should be interpreted reasonably and with common sense. The clear implication of these comments is that the regulations are subject to a more literal interpretation that would impose unreasonable burdens on tax advice. While we agree with the sentiments expressed by these Treasury officials, an employee of the Office of Professional Responsibility, an administrative law judge, or a Court could well apply the plain language of the regulations literally. Thus, we

179. Sheryl Stratton, *Circular 230 Rules Examined at D.C. Bar Tax Section Meeting*, TAX NOTES TODAY, Feb. 3, 2005 available at LEXIS, Fedtax Library, 2005 TNT 22-3.

180. Sheryl Stratton, *Common Sense Urged By IRS At Circular 230 Program*, TAX NOTES TODAY, May 11, 2005 available at LEXIS, Fedtax Library, 2005 TNT 90-3.

181. Sheila R. Cherry, *Treasury Officials List Document Exemptions Under Final Circular 230 Regulations*, BNA PENSION & BENEFITS DAILY, Aug. 17, 2005.

182. Stratton, *supra* note 134.

183. Dustin Stamper, *Circ. 230 Amendments to Address Disclosure*, IRS Official Says, 109 TAX NOTES, 736, Nov. 7, 2005.

184. *Firms Should Enact Companywide Programs To Comply With Circular 230*, Whitlock Says, U.S. LAW WEEK, Dec. 13, 2005, at 2349.

believe that the exceptions and clarifications set forth in this report should be adopted or that the preamble to the regulations should expressly state that the regulations should be interpreted reasonably in the context of the circumstances (or both).¹⁸⁵

In a speech on September 30, 2005, the IRS Chief Counsel Donald Korb said that the IRS wanted to find a way to exclude routine advice from the covered opinion rules, but it proved too difficult.¹⁸⁶ With all the brainpower and experience at their disposal, it is difficult to believe that the Treasury Department and the IRS could not craft regulations that target the perceived abuses more narrowly. Any regulation that prompts otherwise sensible law firms to add disclaimers to every e-mail they send out, however innocuous, needs to be fixed- quickly.¹⁸⁷

POSTSCRIPT

Circular 230 compliance is a moving target, and new developments occur frequently. Accordingly, this section of the article will summarize briefly some developments that have occurred since the article was written.

On December 9, 2005, Eric Solomon, deputy assistant Treasury secretary (regulatory affairs) said that the reaction to the regulations “could indicate they’ve been written too meticulously” and that “[m]aybe we should think about writing the rules in a different way – more as broad principles.”¹⁸⁸

The American Bar Association Section of Taxation has requested revisions and additional guidance, because the new rules have increased practitioner burdens to a greater extent than they have combated abusive tax practices.¹⁸⁹

The National Conference of Lawyers and CPAs has submitted comments to the IRS, asserting that the “new rules extend their reach well beyond the world of abusive tax shelters and products, and into the realm of everyday tax advice.”¹⁹⁰

Treasury Tax Legislative Counsel Michael Desmond said on January 31, 2006 that:

185. NYSBA REPORT, *supra* note 52.

186. Tandon, *supra* Note 108.

187. In a speech on December 1, 2005, Stephen Whitlock described this as an “unfortunate development”, but did not say what the I.R.S. might do about it. *Firms Should Enact Companywide Programs To Comply With Circular 230*, Whitlock Says, U.S. LAW WEEK (BNA), Dec. 13, 2005, at 2349.

188. Dustin Stamper, *Solomon Suggests IRS and Treasury May Need to Rethink Circular 230 Approach*, TAX NOTES TODAY, Dec. 12, 2005, available at LEXIS, Fedtax Library, 2005 TNT 237-2.

189. *ABA Section of Taxation Seeks Circular 230 Modifications To Reduce Compliance Burden*, PENSION & BENEFITS REPORTER, Dec. 13, 2005, at 2701.

190. Herbert N. Beller, *Lawyers, CPAs Urge Treasury, IRS To Revisit Circular 230 Rules*, TAX NOTES TODAY, Jan. 24, 2006, at 15-16.

Treasury would stick by its approach of attempting to define the class of transactions for which full-blown opinions are required. Treasury will attempt to further refine and narrow the definition. He acknowledged that the definition of marketed opinion is overbroad, as practitioners have complained. He argued that the class of transactions meant to be covered by full-blown opinions is supposed to be a tiny percentage of all transactions. An ordinary transaction should not require an opinion.¹⁹¹

In speeches on February 10, 2006, and May 10, 2006, Stephen Whitlock, now the acting director of OPR, defended the new proposed regulations, saying that opening up disciplinary proceedings for alleged violations of Circular 230 will benefit taxpayers as much as the IRS because a body of case law will be developed.¹⁹²

Additional comments on the regulations have been submitted to the IRS by the American Institute of Certified Public Accountants¹⁹³ and by the New York State Bar Association Tax Section.¹⁹⁴ Academic commentary has been mixed, with Prof. Deborah Schenk of NYU School of Law arguing that the regulations should be scrapped¹⁹⁵ and Dennis Ventry of UCLA School of Law arguing that Circular 230 is necessary.¹⁹⁶

On May 5, 2006, Michael Desmond, Treasury Department Tax Legislative Counsel, told the ABA Section of Taxation that a Treasury and IRS working group continues to analyze ways of correcting what he called a "scope problem and breadth problem" and the overuse of disclaimers.¹⁹⁷

Finally, in the most dramatic and unexpected recent development, Cono Namorato, who resigned earlier this year as director of OPR, said that the covered opinion rules of section 10.35 are unnecessary and should be repealed, the rules of section

191. Lee Sheppard*News Analysis: Tax Legislative Counsel Discusses Circular 230*, TAX NOTES TODAY, Feb. 2, 2006, available at LEXIS, Fedtax Library, 2006 TNT 22-4.

192. *Whitlock Defends Proposed Circular 230 Amendments*, TAX NOTES TODAY, February 13, 2006, available at LEXIS, Fedtax Library, 2006 TNT 29-3; *ABA Tax Section Meeting: Circular 230 Panel looks at Fees, Conflicts, and Transparency*, 111 TAX NOTES 765 (May 15, 2006).

193. *AICPA Comments on Circular 230 Standards*, TAX NOTES TODAY, March 7, 2006, available at LEXIS, Fedtax Library, 2006 TNT 44-16.

194. *NYSBA Tax Section Members Submit Revised Version of Proposed Circular 230 Regs*, TAX NOTES TODAY, May 3, 2006, available at LEXIS, Fedtax Library, 2006 TNT 85-19.

195. *The Circular 230 Amendments: Time to Throw Them Out and Start Over*, TAX NOTES TODAY, March 21, 2006, available at LEXIS, Fedtax Library, 2006 TNT 54-24.

196. *Raising the Ethical Bar for Tax Lawyers: Why We Need Circular 230*, TAX NOTES TODAY, May 16, available at LEXIS, Fedtax Library, 2006 TNT 94-35

197. *Treasury Opposes Tax Return Disclosures; Circular 230 Debate Ongoing, Desmond Says*, PENSION & BENEFITS REPORTER (BNA), May 16, 2006, at 1214.

10.36 should be expanded to require employers to ensure compliance with all of the requirements of Circular 230, and that IRS should use the traditional provisions of Circular 230, including the due diligence provisions of section 10.22.¹⁹⁸ He added, expressing an opinion that few practitioners are likely to share, that the government has nothing to apologize for, because the section 10.35 rules were “exactly what was needed at the time, and they succeeded in getting everyone’s attention.”¹⁹⁹

FACT PATTERN AND QUESTIONS

Note: This fact pattern, and the questions posed at the end of the fact pattern, are designed to illustrate the fact that the Circular 230 regulations can potentially affect issues that arise every day in a benefits practice. The suggested answers represent the views of the author and have not been discussed with or approved by the IRS or any of its personnel. In approaching these issues, a decision tree may be helpful. Several good decision trees have been published, though none of those with which the author is familiar are specifically geared to employee benefits issues.²⁰⁰

The Fact Pattern

Four physicians split off from a large multi-specialty group to form their own practice. Each of them has a 25% interest in the new LLC. They range in age from 37 to 66. They have 10 employees. They expect the new practice to be very successful, but it will be some time before their actual collected income will reach its full potential.

The physicians receive benefit planning advice from three sources, their accountant (Alison) who has no particular benefits expertise, their lawyer (Len), who hasn’t really come to grips with the enactment of ERISA but has never been known to admit ignorance on any topic, however recherche, and their TPA (Tom), who handled plan administration for their former employer. Tom is not a CPA, enrolled actuary, attorney or enrolled agent, but has 25 years’ experience designing and administering employee benefit plans.

In each case, assume that the LLC, not the individual physicians, is the client. Assume also that each piece of advice described below is given separately, in writing.

198. *Covered Opinion Standards Should Be Repealed, Namorato Says*, TAX NOTES TODAY, May 9, 2006, available at LEXIS, Fedtax Library, 2006 TNT 89-3.

199. *Id.*

200. See e.g., Blattmachr, et al., *Decision-Tree for Potential Application of Circular 230, Section 10.35*, available at [www.ilsdocs.com/docs/alerts/Decision_Tree_circular_230_\(Blattmachr\).pdf](http://www.ilsdocs.com/docs/alerts/Decision_Tree_circular_230_(Blattmachr).pdf).

Len's law firm routinely attaches a "not for penalty protection" disclaimer to every communication it sends out, including Christmas cards. Len has told his clients to ignore the disclaimer as it is "meaningless".²⁰¹ Alison and Tom do not follow this practice. Consider the possible application of the Circular 230 regulations to each piece of advice, how the advice is likely to be classified under the regulations, and whether any exception is necessary or available. Consider also whether the answer is affected by the identity of the person who actually gives the advice, i.e., Alison, Len or Tom.²⁰² Consider also whether the answer is affected by whether the advice is contained in (i) an e mail or a letter, (ii) in a one paragraph letter or a 5 page letter, or (iii) in a short, informal letter or a lengthy, detailed and turgid 78 page memorandum.²⁰³ Consider also whether the answer is affected by whether the physicians are highly sophisticated tax minimizers, who have never met a loophole or tax shelter that they didn't like, or are complete innocents who do not want any trouble, ever, with IRS, and simply trust their advisors to keep them out of trouble.²⁰⁴

Question 1:

The practice has budgeted \$100,000 per year for retirement plan contributions, and wants this to be the exact amount of the employer contribution for each of the first 5 years. The plan design is to be simple. The LLC asks for advice as to the alternatives available.

201. See *supra* Parts IV.B.3-4 above. Query whether Len's statements nullify the effectiveness of the disclaimer.

202. Alison and Len are practitioners, as defined in 31 C.F.R. § 10.2(e); see *supra* Part III.B. Tom is not a practitioner. However, if any member of Tom's firm is a practitioner with responsibility for overseeing the firm's tax practice (whatever that means) the firm's procedures for all employees must be consistent with the best practices described in 31 C.F.R. § 10.33.

203. If the advice is a covered opinion, the length of the communication appears to be immaterial, except that it will be difficult if not impossible to satisfy the covered opinion requirements in a brief communication. See *supra* Part IV.B. for a discussion of the requirements for covered opinions. If, however, the advice is subject only to the section 10.37 requirements for other written advice, then the length may be a factor. All facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client, will be considered in determining whether a practitioner has failed to comply with the requirements of 31 C.F.R. section 10.37.

204. This factor may bear on their intent, particularly the issue of whether the transaction is a principal purpose transaction, a significant purpose transaction, or neither. See *supra* Part IV.B.5 for a discussion of principal purpose and significant purpose transactions.

Answer:

This advice appears to involve a federal tax issue.²⁰⁵ It is not clear that the advice would be within the qualified plan exception.²⁰⁶ This does not appear to be a principal purpose transaction, but it could well be a significant purpose transaction.²⁰⁷ If so, and if the advice is provided by a practitioner (Alison or Len), then it will be a covered opinion unless (1) the advice does not address any significant federal tax issue²⁰⁸ or (2) the advice includes a valid not-for penalty protection disclaimer.²⁰⁹ A limited scope opinion would be permissible.²¹⁰ Even if the advice is not a covered opinion, it will be subject to the requirements for other written advice if provided by a practitioner (Alison or Len).²¹¹

Question 2:

(a) They decide to adopt a safe harbor 401(k) plan, using the non-elective employer contribution. All employer contributions are to be allocated in proportion to 415 compensation. Tom drafts the plan (using a pre-approved prototype), SPD, QDRO and loan procedures, deferral elections and other administrative forms. Len reviews all these documents and gives his opinion that they comply with all applicable requirements of the Code and ERISA.

(b) Same as (a), but they decide to adopt a SEP rather than a 401(k) plan.

Answer:

Are plan documents, summary plan descriptions (SPDs) and related administrative forms subject to the Circular 230 requirements at all?²¹² If so, are they still subject to the requirements when drafted by a non-practitioner?

Len's advice appears to involve a federal tax issue, insofar as it relates to the Code rather than ERISA.²¹³ It is not clear that the advice would be within the qualified plan exception,²¹⁴ particularly if they adopt a SEP (which is not a qualified plan) rather than a 401(k) plan.²¹⁵ This does not appear to be a principal purpose transaction, but it could well be a significant purpose

205. See 31 C.F.R. § 10.35(b)(3).

206. 31 C.F.R. § 10.35(b)(2)(ii)(B)(1).

207. See *supra* Part IV.B.5.

208. See 31 C.F.R. § 10.35(b)(3); see also *supra* Part IV.B.3.

209. See 31 C.F.R. § 10.35(b)(4)(ii); see also *supra* Part IV.B.3.

210. See 31 C.F.R. § 10.35(c)(3)(v); see also *supra* Part IV.B.7.

211. See 31 C.F.R. § 10.37; see also *supra* Part IV.D.

212. See *supra* note 173 and accompanying text.

213. See 31 C.F.R. § 10.35(b)(3).

214. See 31 C.F.R. § 10.35(b)(2)(ii)(B)(1); see also *supra* Part V.B.

215. See *supra* note 173 and accompanying text.

transaction.²¹⁶ If so, and as the advice is provided by a practitioner (Len), then it will be a covered opinion unless (1) the advice does not address any significant federal tax issue²¹⁷ or (2) the advice includes a valid not-for penalty protection disclaimer.²¹⁸ A limited scope opinion would be permissible.²¹⁹ Even if the advice is not a covered opinion, it will be subject to the requirements for other written advice.²²⁰

Question 3:

Some time later, the LLC contacts the advisors after hearing about the availability of Roth contributions to a 401(k) plan. They request an explanation of the pros and cons of adding a Roth feature.

Answer:

This advice appears to involve a federal tax issue.²²¹ It is not clear that the advice would be within the qualified plan exception.²²² This does not appear to be a principal purpose transaction, but it could well be a significant purpose transaction.²²³ If so, and if the advice is provided by a practitioner (Alison or Len), then it will be a covered opinion unless (1) the advice does not address any significant federal tax issue²²⁴ or (2) the advice includes a valid not-for penalty protection disclaimer.²²⁵ A limited scope opinion would be permissible.²²⁶ Even if the advice is not a covered opinion, it will be subject to the requirements for other written advice if provided by a practitioner (Alison or Len).²²⁷

Question 4:

One of the partners returns from a golf game with a colleague, Dr. Blowhard, with exciting news. By using a technique called cross-testing, Blowhard's practice has cut the amount allocated to non-physicians from 20% of the employer contribution to only 5%. They are not sure whether this would be right for them - they value their employees and want to take care of them - but they would like an explanation of how cross-testing could increase

216. See *supra* Part IV.B.5.

217. See 31 C.F.R. § 10.35(b)(3); see also *supra* Part IV.B.3.

218. See 31 C.F.R. § 10.35(b)(4)(ii); see also *supra* Part IV.B.3.

219. See 31 C.F.R. § 10.35(c)(3)(v); see also *supra* Part IV.B.7.

220. See 31 C.F.R. § 10.37; see also *supra* Part IV.D.

221. 31 C.F.R. § 10.35(b)(3).

222. 31 C.F.R. § 10.35(c)(2); *supra* Part V.B.

223. See *supra* Part IV.B.5

224. 31 C.F.R. § 10.35(b)(3); *supra* Part IV.B.3.

225. 31 C.F.R. § 10.35(b)(4); *supra* Part IV.B.3.

226. 31 C.F.R. § 10.35(c)(2)(v); *supra* Part IV.B.7.

227. 31 C.F.R. § 10.37(a); *supra* Part IV.D.

the amounts allocated to the physicians. Tom prepares illustrations.

Answer:

This advice appears to involve a federal tax issue.²²⁸ It is not clear that the advice would be within the qualified plan exception.²²⁹

This may be a principal purpose transaction,²³⁰ even if it is not, it could well be a significant purpose transaction.²³¹ If so, and if the advice were provided by a practitioner (Alison or Len), then it would be a covered opinion unless (1) the advice does not address any significant federal tax issue²³² or (2) the transaction is only a significant purpose transaction and the advice includes a valid not-for penalty protection disclaimer.²³³ A limited scope opinion would be permissible if the transaction is only a significant purpose transaction.²³⁴ Even if the advice is not a covered opinion, it would be subject to the requirements for other written advice if provided by a practitioner (Alison or Len).²³⁵ Here, however, the illustrations are provided by Tom, who is not a practitioner. Accordingly, it seems that neither section 10.35 nor section 10.37 would apply, but section 10.33 (best practices) might apply.²³⁶

Question 5:

Alison advises the physicians that, as their income from the practice has increased substantially, they could contribute and deduct far more than the original \$100,000 per year. They request Tom to prepare, and Len to review, illustrations of the maximum annual deductible contribution and different ways that it could be allocated between the participants.

Answer:

This advice appears to involve a federal tax issue.²³⁷ It is not clear that the advice would be within the qualified plan exception.²³⁸

228. 31 C.F.R. § 10.35(b)(3).

229. 31 C.F.R. § 10.35(b)(4)(ii)(b1); *supra* Part V.B.

230. 31 C.F.R. § 10.35(b)(10); *supra* note 139 and accompanying text. Is the purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose?

231. *See supra* Part IV.B.5.

232. 31 C.F.R. § 10.35(b)(3); *supra* Part IV.B.3.

233. 31 C.F.R. § 10.35(b)(4)(ii); *supra* Part IV.B.3 above.

234. 31 C.F.R. § 10.35(c)(2)(v); *supra* Part IV.B.7.

235. 31 C.F.R. § 10.37(a); *supra* Part IV.D.

236. *See supra* Part IV.A and IV.C.

237. 31 C.F.R. § 10.35(b)(3).

238. 31 C.F.R. § 10.35(c)(2); *supra* Part V.B.

This may be a principal purpose transaction.²³⁹ even if it is not, it could well be a significant purpose transaction.²⁴⁰ If so, any written advice provided by a practitioner (Len), will be a covered opinion unless (1) the advice does not address any significant federal tax issue²⁴¹ or (2) the transaction is only a significant purpose transaction and the advice includes a valid not-for penalty protection disclaimer.²⁴² A limited scope opinion would be permissible if the transaction is only a significant purpose transaction.²⁴³

Even if the advice is *not* a covered opinion, written advice provided by Len would be subject to the requirements for other written advice.²⁴⁴ The illustrations are provided by Tom, who is not a practitioner. Accordingly, it seems that neither section 10.35 nor section 10.37 would apply to the illustrations, but section 10.33 (best practices) might, and section 10.33 would also apply to any oral advice provided by Len.²⁴⁵

Question 6:

The oldest partner, Jack, has just celebrated his 70th birthday. He has no intention of retiring (to his partners' chagrin), but he has heard that he may have to start taking money out of the plan. The practice asks Tom and Len for advice on (i) the amount that must be taken out each year and (ii) the penalty for failing to do so.

Answer:

The minimum distribution requirement²⁴⁶ is a plan qualification requirement, so advice on this issue appears to involve a federal tax issue.²⁴⁷ The penalty for failing to take a required minimum distribution is an excise tax,²⁴⁸ so advice on this issue appears not to involve a federal tax issue.²⁴⁹ It is not clear that the advice would be within the qualified plan exception.²⁵⁰

239. 31 C.F.R. § 10.35(b)(10); *see supra*, note 139 and accompanying text. Is the purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose?

240. *See supra* Part IV.B.5.

241. 31 C.F.R. § 10.35(b)(3); *see supra* Part IV.B.3.

242. 31 C.F.R. § 10.35(b)(4)(ii); *see supra* Part IV.B.3.

243. 31 C.F.R. § 10.35(c)(3)(v); *see supra* Part IV.B.7.

244. 31 C.F.R. § 10.37; *see supra* Part IV.D.

245. *See supra* Part IV.A and IV.C.

246. I.R.C. § 401(a)(9).

247. *See* 31 C.F.R. § 10.35(b)(3).

248. I.R.C. § 4974 (2000).

249. *See supra* note 123 and accompanying text.

250. 31 C.F.R. § 10.35(c)(2); *supra* Part V.B.

This does not appear to be a principal purpose transaction;²⁵¹ however, it could be a significant purpose transaction.²⁵² If so, any written advice provided by a practitioner (Len), will be a covered opinion unless (1) the advice does not address *any* significant federal tax issue²⁵³ or (2) the advice includes a valid not-for penalty protection disclaimer.²⁵⁴ A limited scope opinion would be permissible.²⁵⁵ Even if the advice is not a covered opinion, written advice provided by Len on the plan qualification requirement would be subject to the requirements for other written advice.²⁵⁶

Question 7:

Another partner, Nina, is only 53, but she is tired of the stress of practicing medicine, and has accepted a teaching position at the local medical school. This involves a large cut in her income, so she wishes to withdraw her account balance, roll it over to an IRA, and start making regular withdrawals from the IRA. The LLC asks for advice on the tax consequences.

Answer:

This advice involves a federal tax issue.²⁵⁷ The advice would probably not be within the qualified plan exception.²⁵⁸ However, this does not appear to be either a principal purpose transaction or a significant purpose transaction because no federal tax is being avoided.²⁵⁹ If so, then it will not be a covered opinion. Even if the advice is not a covered opinion, it will be subject to the requirements for other written advice if provided by a practitioner (Alison or Len).²⁶⁰

Question 8:

The LLC practices in a state with relatively high state income taxes. The state generally follows the federal rules for determining taxable income, but there are some special exclusions for retirement income. The LLC requests advice on the state tax consequences of the distributions to Jack and Nina.

251. Again, is not at all clear that 31 CFR § 10.35(b)(10) applies: is the "purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose[?]" ; see also *supra* notes 139-142 and accompanying text.

252. See *supra* Part IV.B.5.

253. See 31 C.F.R. § 10.35(b)(3); *supra* notes 124-25 and accompanying text.

254. See 31 C.F.R. § 10.35(b)(4); see also *supra* note 126 and accompanying text.

255. 31 C.F.R. § 10.35(c)(3)(v); see also *supra* Part IVB.

256. See 31 C.F.R. § 10.37; see also *supra* Part IV.D.

257. See 31 C.F.R. § 10.35(b)(3).

258. See *supra* note 240 and accompanying text.

259. See *supra* Part IV.D.

260. See 31 C.F.R. § 10.37; see also *supra* Part IV.D.

Answer:

This advice does not involve a federal tax issue,²⁶¹ so none of the requirements of the regulations would apply. However, it would be necessary to research state law to determine whether the state tax department has issued similar regulations with respect to state tax issues.

Question 9:

Some years later, the practice is generating income faster than the doctors (and their children) can spend it. They tell their advisors that, because they are taxed individually on their share of the LLC's income, they each have far more taxable income than they want or need. Find us more deductions, they cry plaintively. At the same time, they are concerned by the rapidly increasing cost of buying out retiring partners and the possible negative consequences of the new Code section 409A rules for non-qualified deferred compensation. Tom suggests that a defined benefit plan could help with both problems. He prepares illustrations of possible plan designs and the associated annual costs.

Answer:

This advice involves a federal tax issue.²⁶² The advice would probably not be within the qualified plan exception.²⁶³

Because of their motivation (saving taxes) this may well be a principal purpose transaction.²⁶⁴ If it is not, it probably is a significant purpose transaction.²⁶⁵ If so, any written advice provided by a practitioner (Len or Alison), will be a covered opinion unless (1) the advice does not address any significant federal tax issue (unlikely),²⁶⁶ or (2) the transaction is only a significant purpose transaction and the advice includes a valid not-for penalty protection disclaimer.²⁶⁷ A limited scope opinion would be permissible if the transaction is only a significant purpose transaction.²⁶⁸

Even if the advice were not a covered opinion, written advice provided by Len would be subject to the requirements for other

261. See 31 C.F.R. § 10.35(b)(3).

262. *Id.*

263. See 31 C.F.R. § 10.35(c)(2); see also *supra* Part V.B.

264. It is not at all clear that 31 CFR section 10.35(b)(10) applies: is the "purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose[?]" ; see also *supra* notes 139-142 and accompanying text.

265. See *supra* Part IV.B.5.

266. See 31 C.F.R. § 10.35(b)(3); see also *supra* Part IV.B.3.

267. See 31 C.F.R. § 10.35(b)(4); see also *supra* Part IV.B.3.

268. See 31 C.F.R. § 10.35(c)(2)(v); see also *supra* Part IV.B.7 above.

written advice.²⁶⁹

The illustrations are provided by Tom, who is not a practitioner. Accordingly, it seems that neither section 10.35 nor section 10.37 would apply to the illustrations, but section 10.33 (best practices) might, and section 10.33 would also apply to any oral advice provided by Len.²⁷⁰

Question 10:

One partner, Fred, has a sister-in-law, Irma, who is a highly successful financial planner. On seeing Tom's illustrations, she snorts with derision and says, "That dude is stuck in the mid-20th century". Irma, a 21st century woman from her elegantly coiffed head to her Dolce & Gabbana clad feet, tells the partners that they can deduct far more than the amounts shown by Tom, and help with their personal and estate planning, by adopting a 412(i) plan and a VEBA that (she claims) qualifies for the 10-or-more-employer exception from the VEBA deduction limitations. She produces two large ring binders containing materials advocating, and describing the tax benefits of, these arrangements, including a 214 page legal opinion from the eminent (in their minds, anyway) law firm Gimme, Shelter and Runne. They send everything to Len for his review, and 2 days later he sends an e mail to the practice, which says simply that, although the techniques are somewhat aggressive, they look OK to him.

Answer:

This raises the stakes considerably: Irma is recommending two separate listed transactions.²⁷¹

Any written advice provided by a practitioner (Len or Alison), will be a covered opinion. Neither a not-for penalty protection disclaimer nor a limited scope opinion would be available.²⁷² Apart from possible disciplinary action by OPR for failing to comply with the regulations, Len has exposed himself to a malpractice action by the LLC for failing to advise them of the risks of these transactions and the possible penalties.²⁷³

Question 11:

The bank which acts as Trustee of the firm's plan asks Tom and Len to work together on preparing brochures for its Trust Department, spelling out the tax advantages of qualified plans and IRAs. The brochures will be given to prospective customers and

269. See 31 C.F.R. § 10.37; see also *supra* Part IV.D.

270. See *supra* Part IV.A and IV.C.

271. See *supra* Part II.B.

272. See 31 C.F.R. § 10.35(c)(2)(v); see also *supra* Part IV.B.7.

273. See *supra* Part II.

their advisors. Tom and Len prepare the brochures, and also speak at seminars hosted by the bank, at which they distribute written outlines discussing retirement planning opportunities.

Answer:

The danger here is that any written material prepared by a practitioner (Len) appears to be within the definition of a marketed opinion,²⁷⁴ even though government officials have denied that this is so. As such, the material must comply with the covered opinion requirements, unless it includes the required disclaimer.

Even if the materials include the disclaimer, written materials provided by Len may be subject to the requirements for other written advice.²⁷⁵

Question 12:

In preparation for filing the 5500, Alison prepares reviewed financial statements for distribution to the partners. She knows that her numbers will be included in the 5500. In her cover letter, she identifies some concerns with particular transactions, and queries whether they violate rules under the Code and/or ERISA. Len prepares the draft 5500, incorporating Alison's numbers, and discusses her concerns in the letter of transmittal to the client. He suggests that they may want to consider correcting any problems under the Employee Plans Compliance Resolution System (EPCRS).²⁷⁶ Len, when consulted, opines in writing that the errors are minor, and do not constitute grounds for disqualification or the imposition of Department of Labor (DOL) penalties, but suggests that he and Tom should nevertheless investigate whether the errors could and should be corrected under EPCRS. Meanwhile, the 5500 is filed with DOL.

Answer:

This advice appears to involve a federal tax issue.²⁷⁷ It is not clear that the advice would be within the qualified plan exception.²⁷⁸ However, assuming that no listed transaction is involved, Len's advice does not appear to be a covered opinion, as it does not involve either a principal purpose transaction, or a significant purpose transaction.²⁷⁹ Even if the advice is not a

274. See 31 C.F.R. § 10.35(b)(5); *see also supra* and Section IV.B.4.

275. See 31 C.F.R. § 10.37; *see supra* Part IV.D.

276. See Rev. Proc. 2006-27, modifying and superseding Rev. Proc. 2003-44, 2003-1 C.B. 1051 (Sept. 22, 2003).

277. See 31 C.F.R. § 10.35(b)(3).

278. See 31 C.F.R. § 10.35(c)(2); *see also supra* Part V.B.

279. See *supra* Part IV.B.5.

covered opinion, it will be subject to the requirements for other written advice.²⁸⁰

Question 13:

On further investigation, Tom and Len discover problems in several areas, the most important of which involve plan loans and ERISA section 404(c). Loans have been made without adequate documentation or security, and in amounts exceeding the limits under Code section 72(p). They conclude that some of the problems can be self-corrected, but others require an EPCRS filing with IRS. Len, with input from Tom, prepares the filing. He also writes to the client separate letters detailing (i) the potential income tax consequences of the errors, (ii) the potential excise taxes under Code section 4975 and (iii) the problems with respect to compliance with ERISA section 404(c).

Answer:

The advice relating to the income tax consequences of the bad loans appears to involve a federal tax issue.²⁸¹ The advice concerning ERISA section 404(c) compliance and the excise taxes²⁸² does not involve a federal tax issue. The advice concerning the income tax consequences would almost certainly not be within the qualified plan exception.²⁸³ However, Len's advice does not appear to be a covered opinion, as it does not involve either a principal purpose transaction, or a significant purpose transaction.²⁸⁴ Even if the income tax advice is *not* a covered opinion, it will be subject to the requirements for other written advice.²⁸⁵

Question 14:

The practice decides to merge with a larger group. As part of its due diligence, the acquirer's law firm asks Len to provide an opinion that the practice's benefit plans comply with ERISA and the Code. Len provides a written opinion to that effect.

Answer:

The opinion relating to compliance with the Code appears to involve a federal tax issue.²⁸⁶ The advice concerning ERISA compliance does not involve a federal tax issue. The opinion would almost certainly not be within the qualified plan exception.²⁸⁷

280. See 31 C.F.R. § 10.37(a); see also *supra* Part IV.D.

281. See 31 C.F.R. § 10.35(b)(2).

282. See *supra* text accompanying note 174.

283. See 31 C.F.R. § 10.35(c)(2); see also *supra* Part V.B.

284. See *supra* Part IV.B.5 above.

285. See 31 C.F.R. § 10.37; see also *supra* Part IV.D

286. See 31 C.F.R. § 10.35(b)(3).

287. See 31 C.F.R. § 10.35(c)(2); see also *supra* Part V.B.

However, Len's opinion does not appear to be a covered opinion, as it does not involve either a principal purpose transaction, or a significant purpose transaction.²⁸⁸ Even if the tax advice is not a covered opinion, it will probably be subject to the requirements for other written advice.²⁸⁹

288. *See supra* Part IV.B.5.

289. *See* 31 C.F.R. § 10.37; *see also supra* Part IV.D.

