# ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

## SUPPLEMENTAL COMMENTS ON CIRCULAR 230 REGULATIONS

***AS REPORTED BY THE COMMITTEES ON ESTATE AND GIFT TAXATION, TAXATION OF BUSINESS ENTITIES, PERSONAL INCOME TAXATION AND TRUSTS, ESTATES AND SURROGATE'S COURTS***

June 6, 2005

This report sets forth the supplemental comments of the Association of the Bar of the City of New York to the final regulations to Circular 230 (the "New Regulations"), as now revised by the final regulations thereto that were published on May 18, 2005 (the "May 18th Regulations," and referred to collectively with the "New Regulations" as the "Circular").[1]

Although we are grateful for the changes that Treasury has made to Circular 230 in response to practitioner comments, we nonetheless believe that the Circular continues to place unwarranted restrictions on routine written tax advice. The likely effect of these restrictions will be both to increase substantially the cost of providing such advice to clients and to establish a "norm" in tax practice whereby legends are routinely employed to elect out of the covered opinion rules so long as the advice does not pertain to principal purpose transactions or listed transactions.[2]

In this Supplemental Report, we address the following four (4) matters upon which we urge Treasury to take action prior to the June 20th effective date of the New Regulations:[3]

(1) The *mismatch* of disclosure standards that would require the practitioner to tell the client that he or she cannot rely on certain tax advice to avoid penalties even though such statement may be incorrect to some extent;

(2) The Circular's overbroad definition of "marketed opinion;"

(3) The failure of the May 18th Regulations to extend to significant purpose transactions the exclusion that is now conferred upon principal purpose transactions that have as their purpose "the claiming of tax benefits in a manner consistent with the statute and Congressional purpose;"[4] and

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1 Our initial comments to Treasury on the Circular 230 Regulations, which were submitted on May 13, 2005, are referenced herein as "Our May 13th Comments".

2 In addition, no election out of the covered opinion rules is permitted for written advice concerning a significant purpose transaction if the written advice is subject to conditions of confidentiality or is subject to contractual protection.

3 Alternatively, we respectfully request that the June 20, 2005 effective date should be postponed for some reasonable period of time (i) to allow practitioners to comment fully on these recently revised regulations and (ii) to give practitioners adequate time to prepare to apply these new rules.

4 Circular § 10.35(b)(10).

(4) The need to clarify the exclusion for preliminary advice.[5]

### *1. Mismatch of Disclosure Standards Relating to the Unavailability of Penalty Protection*[6]

Although we recognize that the Circular's disclosure provisions are intended to prevent certain taxpayers from being able to rely on written tax advice to avoid penalties, the means employed by the Circular to accomplish that objective creates a *mismatch* of disclosure standards. In some instances, this mismatch will have the unfortunate result of requiring the practitioner to state that the advice given cannot be relied upon to avoid penalties even though that statement may be untrue, at least to some extent.

Not all advice provided by practitioners requires a more likely than not level of confidence in order for the taxpayer to avoid penalties. The more likely than not standard is relevant under current law to certain transactions resulting in understatements of Federal income tax.[7] Penalties related to other tax matters can generally be avoided based on less stringent standards. For example, underpayments attributable to negligence or disregard of rules or regulations can be avoided based on a "reasonable basis" standard.[8]

Circular Section 10.35(e)(4) provides, however, that an opinion failing to reach a more likely than not conclusion with respect to a significant Federal tax issue must prominently disclose that "[w]ith respect to those significant Federal tax issues, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer."[9]

What happens if a practitioner renders advice that constitutes a covered opinion based on a "reasonable basis" standard? This could occur, for example, if the advice relates to a principal purpose transaction. It appears that Circular Section 10.35(e)(4) would require the practitioner to tell his or her client that, with respect to any significant Federal tax issues on which the practitioner has failed to reach a more likely than not confidence level (which could well occur in a reasonable basis opinion), the opinion cannot be used by the taxpayer to avoid any penalties imposed by the Internal Revenue Code *notwithstanding that the tax law allows the taxpayer to avoid certain penalties by relying on a reasonable basis opinion*.[10]

We do not believe that Treasury intended to saddle practitioners with this Hobson's choice in determining how to advise his or her client. Accordingly, we respectfully request that

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5 The May 18th Regulations also overlooked a typographical error appearing in Circular Section 10.35(b)(2)(ii)(B). Specifically, the cross-reference in that paragraph to Circular Section 10.35(b)(2)**(ii)**(B) instead should be to Circular Section 10.35(b)(2)**(i)**(B).

6 This point is further discussed in Recommendation L of Our May 13th Comments.

7 See IRC § 6664(d).

8 See IRC § 6662(b)(l); Treasury Regulations § 1.6662-3(b)(3).

9 Circular § 10.35(e)(4)(ii).

10 See id.

Treasury correct this inconsistency by revising Circular Section 10.35(e)(4) to state as follows (with proposed language underscored):

> **(4) Opinions that fail to reach a more likely than not conclusion** -- An opinion that does not reach a conclusion at a confidence level of at least more likely than not with respect to <u>one or more</u> significant Federal tax issue<u>s addressed by the opinion, to the extent that such confidence level is necessary to avoid penalties,</u> must prominently disclose that –
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> (i) The opinion does not reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues addressed by the opinion; and
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> (ii) With respect to those significant Federal tax issues, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer."[11]

### *2. The Circular's Overbroad Definition of "Marketed Opinion"[12]*

The term "marketed opinion" should be defined differently. The current definition, which is set forth in paragraph (b)(5) of Circular Section 10.35, provides as follows:

> (5) Marketed opinion - (i) Written advice [concerning a significant purpose transaction] is a marketed opinion if the practitioner knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).

A literal application of this definition would encompass many writings that have no bearing whatsoever on abusive tax shelters or "fringe" tax advice.

This problem is particularly acute in the context of business transactions. There is a wide scope of business dealings that involve "recommending" that do not fall within the type of tax shelter promotion that is the intended target of the Circular. Business partners frequently "recommend" transactions to each other without any intention of becoming tax shelter promoters. Tax advice that one party has received may be proffered to another as a way of

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[11] This issue also arises in connection with the definition of a "reliance opinion." Circular Section 10.35(b)(4) defines a reliance opinion as an opinion that reaches a confidence level of more likely than not on one or more significant Federal tax issues, unless the opinion prominently discloses that it cannot be used to avoid penalties that may be imposed on the taxpayer. The disclosure required by Circular Section 10.35(b)(4)(ii) should accordingly be modified to say that the opinion may not be relied on to avoid those penalties that require a more likely than not opinion to avoid penalties. <u>See</u> Comments on Circular 230 Regulations, dated April 6, 2005, submitted by the American College of Trust and Estate Counsel (hereinafter the "ACTEC April 2005 Comments"), at 23.

[12] This point was addressed in Recommendation H of Our May 13th Comments.

encouraging the second party to agree to a business transaction. Likewise, a corporation may share tax advice that it has received with its shareholders in recommending a transaction. Thus, for example, a standard closing opinion which opines that a transaction is a tax-free reorganization will frequently be shared with the corporation's shareholders to encourage their approval of the transaction. Further, tax advice provided to a client may be shared between parties to a joint venture, including limited partners who subscribe for an interest in the venture in the hope of making a tidy profit. Certainly, these circumstances should all be excluded from the covered opinion requirements.[13]

In addition, a literal application of the definition of marketed opinion would encompass articles and outlines written for publication in periodicals and for distribution at seminars, e-mail exchanges on "list-serves" and "blogs" and other informal discussions among professionals, material describing non-controversial tax techniques that appear in brochures, and written advice shared among related taxpayers.[14]

We accordingly recommend that the definition of marketed opinion be revised to exclude such benign tax advice. The May 18th Regulations provide an example of how this may be accomplished through its exclusion (in its definition of "principal purpose") of advice that relates to a partnership, entity, plan or arrangement that has "as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose."[15] If similar exclusionary language were employed in the definition of marketed opinion and broadened to exclude writings prepared for non-commercial or educational purposes, then the large majority of our concerns relating to the definition of marketed opinion will have been addressed.

### *3. The May 18th Regulations Should Have Extended to Significant Purpose Transactions the Exclusion that it Conferred upon Principal Purpose Transactions that have as their Purpose the Claiming of Tax Benefits in a Manner Consistent with the Statute and Congressional Purpose*

The May 18th Regulations have carved out an exclusion from the definition of "principal purpose" that applies where the "partnership, entity, plan or arrangement has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose."[16] The May 18th Regulations, however, do not extend this exclusion to significant purpose transactions. Specifically, Circular Section 10.35(b)(10) provides that "[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)."[17]

We do not understand the reasoning behind this distinction. Indeed, this distinction impresses us as illogical because, of these two categories of transactions, the significant purpose

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13 See New York State Bar Association Tax Section Report on Circular 230 Regulations, dated March 3, 2005, at recommendation entitled "Marketed Opinions."

14 ACTEC April 2005 Comments at 16-17.

15 Circular § 10.35(b)(10).

16 Id.

17 Id.

transactions have the lower level of tax motivation. Accordingly, the Circular should be revised to extend this exclusion to significant purpose transactions as well.

### *4. The Exclusion for Preliminary Advice Should Be Clarified*[18]

Finally, we request that guidance be provided concerning the exclusion for preliminary advice that is contained in Circular Section 10.35(b)(2)(ii)(A). This provision excludes from the definition of covered opinion "[w]ritten advice provided to a client during the course of an engagement if a practitioner is reasonably expected to provide subsequent written advice to the client that satisfies the requirements of this section."[19]

Guidance is needed on the following issues so that practitioners will know under what circumstances they can rely on this exception:

1) Must the practitioner who is referenced in this exclusion be the same practitioner who is rendering the preliminary advice? Because this exclusion refers to "*a* practitioner" (as opposed to "*the* practitioner"), the answer to this question presumably would be "no."

2) What does it mean for the subsequent written advice to satisfy "the requirements of this section?" Does that require the practitioner providing the written advice to have a reasonable expectation that a covered opinion will ultimately be rendered? Or will this exclusion for preliminary advice also be available if the practitioner has a reasonable expectation that, at some point in the future, a practitioner will "elect out" of the requirement for issuing a covered opinion as permitted by Circular Section 10.35?

3) How far into the future can the practitioner look in evaluating whether subsequent written advice satisfying Circular Section 10.35 is likely to be issued?

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[18] This point was discussed in Recommendation D of Our May 13th Comments.

[19] Circular § 10.35(b)(2)(ii)(A).