

**AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION  
ADMINISTRATIVE RECOMMENDATION REGARDING  
REGULATIONS GOVERNING PRACTICE  
BEFORE THE INTERNAL REVENUE SERVICE**

This recommendation is for an amendment to the regulations regarding practice before the Internal Revenue Service at 31 CFR § 10.1 et seq. (“Circular 230”). The recommendation is by the Section of Taxation (the “Section”) of the American Bar Association. The Board of Governors or the House of Delegates of the American Bar Association has not approved the recommendation, and it does not necessarily represent and should not be construed as the policy of the American Bar Association.

Although many of the members of the Section who participated in preparing this recommendation have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, and all would be affected in their capacity as practitioners, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make, or has a specific individual interest in making, a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of this recommendation.

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Date: August 13, 2001

## REPORT

The ABA Section of Taxation (the "Section") recommends that the Treasury Department revise section 10.35 of the proposed Circular 230 regulations, dealing with tax shelter opinions. The revised section 10.35 would combine the subject matter of two sections in the proposed regulations: section 10.33, concerning opinions used by a third party to market a tax shelter, and section 10.35, concerning opinions that the proposed treatment of a tax shelter is more likely than not the proper treatment. If the recommendation is adopted, sections 10.33 and 10.35 of the proposed regulations would be withdrawn, and the revised section 10.35 would replace them.

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

### I. Explanation of the Recommendation

#### A. Background

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

The January 12 proposed regulations provided generally that a tax shelter opinion would have to address all material issues in the transaction if either (1) the opinion reached a conclusion that it was more likely than not that the proposed treatment of the tax shelter was the proper treatment, or (2) the practitioner knew that a third party promoter would use the opinion in marketing the tax shelter to taxpayers. Tax shelters were defined by reference to section 6662 as transactions with a "significant purpose" of avoidance of Federal income tax,<sup>1</sup> with exceptions for municipal bond issues and qualified retirement plans. The preamble to the January 12 proposed regulations requested comments on other transactions that should be excepted. The preamble also indicated that the Treasury Department intended to modify the advice standards in the regulations under the penalty provisions of sections 6662 and 6664 of the Internal Revenue Code to provide that opinions can be relied on to satisfy those standards only if they satisfy the standards of Circular 230. The Section supports such a change to the regulations under Sections 6662 and 6664.

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

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

B. Summary

The Section is submitting these additional comments because of its concern that the various proposals that have been made to date do not appropriately or adequately address the "tax shelter" problem that has emerged over the past several years. The Section has previously commented that the definition of a tax shelter in sections 10.33 and 10.35 of the proposed regulations is too broad. See the Section's comments dated April 30, 2001 (the "Prior Comments"). The Section proposed in the Prior Comments that this definition be replaced with a definition that emphasized "the principal purpose" of the transaction relating to the written advice. Other practitioners also objected to the breadth of the definition of a tax shelter in the proposed regulations.

Upon further reflection, the Section has concluded that refinement to these definitions is needed to address valid concerns raised by practitioners while continuing to take into account the government's interests. To achieve the appropriate balance, the Section has developed alternative tests for determining whether written advice provided by a practitioner relates to a tax shelter and, therefore, should be subject to heightened practitioner diligence under Circular 230.

Under the Recommendation, a tax shelter is a transaction that satisfies any one of three alternative tests. The three alternative tests are:

- (1) The transaction is a “listed transaction” subject to disclosure on corporate returns under Treas. Reg. § 1.6011-4T(b)(2);
- (2) The principal purpose of the transaction is to avoid or evade Federal income tax; or
- (3) A significant purpose of the transaction is to avoid or evade federal income tax; and:
  - (a) the practitioner has reason to believe or actual knowledge that the taxpayer has participated in the transaction under conditions of confidentiality;
  - (b) the practitioner has reason to believe or actual knowledge that the taxpayer has obtained contractual protection against the possibility that the intended tax benefits will not be sustained;
  - (c) the practitioner receives a fee (other than a fee based on a

reasonable stated hourly rate) that is contingent on the taxpayer's participation in the transaction or is measured by the actual or estimated tax benefits of the transaction;

- (d) the practitioner has reason to believe or actual knowledge that the opinion will be used by a party other than the practitioner or the practitioner's firm to market or promote the transaction to taxpayers; or
- (e) the transaction is "actively marketed or promoted as a tax shelter" by the practitioner (or the practitioner's firm).

The second and third tests are subject to an exception for transactions clearly consistent with the purposes of the applicable provisions of the Internal Revenue Code and transactions reviewed by the Service prior to implementation by the taxpayer. An opinion with respect to a tax shelter as thus defined must address all issues as to which the Service would have a reasonable basis for denial of claimed tax benefits.

The main premise of the Recommendation is that the Treasury Department and the Internal Revenue Service have a legitimate interest in regulating the activities of practitioners who give advice as to tax shelters. The Section recognizes that in some situations the purpose of a tax shelter opinion is primarily to afford the taxpayer a claim of reasonable belief, reasonable cause, or good faith under the penalty provisions of sections 6662 and 6664 ("penalty protection"). Arguably, the goals of Circular 230 concerning tax shelter opinions could be achieved by making Circular 230 applicable to, and only to, opinions offered for purposes of penalty protection. The Recommendation makes Circular 230 applicable to any opinion concerning a tax shelter, as defined, regardless of whether the opinion is intended to create penalty protection, because tax shelter advice that does not meet the standards of Circular 230 undermines the integrity of the tax system. The Section believes that the attractiveness of inappropriate tax shelter transactions will be reduced if practitioners are required to disclose all of the relevant issues and risks to taxpayers.

### C. Tax Shelter Definition

The definition of a tax shelter in this proposal is intended to identify transactions in which there is a reason to require full discussion by the practitioner of all material tax issues relating to the transaction. The first test for a tax shelter relates to listed transactions, which are transactions that have been identified by the Internal Revenue Service as involving tax avoidance or evasion. This test does not have any reference to the purpose of the transaction; all listed transactions would be treated as tax shelters for purposes of Circular 230. The exception for transactions that are clearly consistent with the Code would not apply to listed transactions under this proposal.

The second test for a tax shelter covers transactions with the principal purpose of tax avoidance or evasion. The Section believes that it is appropriate to regulate the conduct of practitioners in rendering written advice with respect to transactions that have the principal

purpose of tax avoidance or evasion because of the significant possibility that the intended tax consequences of such transactions could be challenged successfully by the Internal Revenue Service.

The third test for a tax shelter applies only to transactions that have a significant purpose of tax avoidance in addition to at least one of certain identified characteristics. The proposed regulations issued by the Treasury Department on January 12 would use the definition in section 6662 (as amended in 1997), which refers to a “significant purpose” test instead of the “principal purpose” of the transaction. The Recommendation, in comparison, would apply to “significant purpose” transactions only if they had at least one of the additional characteristics stated in the Recommendation. The Recommendation uses a narrower definition of tax shelter for Circular 230 than section 6662 because the regulation of practitioners under Circular 230 is supplemental to a broad body of existing professional regulation and therefore should be limited in its application to the extent consistent with tax administration concerns.

In order to be subject to Circular 230, an opinion with respect to a transaction that has a significant purpose of tax avoidance must have at least one of five other characteristics of a potentially abusive transaction. The first three characteristics are based upon the factors set forth in Treas. Reg. §§ 1.6011-4T(a)(3)(i)(A), (B) and (C). They pertain to written advice provided (i) under conditions of confidentiality, (ii) in connection with a transaction in which the taxpayer has obtained or been provided with contractual protection against the loss of the tax benefits involved, or (iii) in connection with a transaction in which the practitioner receives a contingent fee. A contingent fee includes any fee that is based upon the tax benefits received by the taxpayer or that is not paid if the transaction does not occur.

For purposes of the contingent fee characteristic, any compensation based upon a reasonable stated hourly rate is not contingent, even if such fee will be paid only if the transaction closes. A "cap" or "ceiling" on fees that is based on a reasonable stated hourly rate does not cause such fees to be contingent. The "reasonable" hourly rate requirement is intended to prevent disguised fixed fee arrangements (e.g., instead of charging a fixed fee of \$100,000, a practitioner charges 10 hours at \$10,000 per hour). Hourly rates that take into account the practitioner's experience, and are roughly commensurate with the highest hourly rates charged by other similarly-experienced practitioners, will be considered "reasonable" for this purpose.

The last two characteristics of a potentially abusive tax shelter relate to opinions used in marketing. The fourth characteristic covers opinions used in "third party" marketing, i.e., the opinion is provided by the practitioner for use by a party other than the practitioner (or the practitioner's firm) in marketing to taxpayers. This test is based upon the current rules in section 10.33 of Circular 230. The Section concurs with the Treasury's conclusion that third-party marketing could be perceived as detrimental to the tax system, so that it is appropriate to apply the Circular 230 requirements to all opinions used in third-party marketing.

The final characteristic addresses active self-marketing by the practitioner (or the practitioner's firm) to its clients. Although mere business promotion and advertising do not raise tax shelter concerns, active self-marketing of a transaction raises an appearance of manipulation

of the tax system. The potential conflict of interest in actively-marketed transactions may discourage full discussion of all relevant facts, legal doctrines and material risks in the transaction. Therefore, this characteristic will be satisfied with respect to a transaction only if, on the basis of all of the facts and circumstances, the practitioner (or the practitioner's firm) has been engaged in a pattern of activity that constitutes active marketing of the transaction. This characteristic is not present merely because a practitioner or the practitioner's firm sends clients a letter or memorandum informing them of new developments or tax planning opportunities, or if the practitioner or the practitioner's firm provides similar tax-planning advice to multiple clients in response to the clients' requests for assistance. However, any such letter or memorandum must clearly state that it is not intended as legal advice, and that the ultimate tax consequences of the transaction will depend upon the particular facts and circumstances. Although the providing of such a letter or memorandum, standing alone, does not give rise to an actively-marketed transaction, all other marketing activities by the practitioner or the practitioner's firm with respect to such transaction must be taken into account in order to determine whether the transaction is actively marketed.

#### D. Exceptions

A transaction that is clearly consistent with the purposes of the Internal Revenue Code will not be considered as having a principal or significant purpose of tax avoidance, and the Recommendation therefore excludes these transactions from the second and third tests (but not for the listed transactions test). Examples of these transactions are provided on the basis of the exclusion in the existing section 6662 regulations together with other items.

The Recommendation recognizes that a transaction that is clearly consistent with the purposes of the Code may be part of a larger transaction that is not clearly consistent with the purposes of the Code. In that event, the Recommendation authorizes the Service to treat the larger transaction as a tax shelter if it satisfies any of the tests in the tax shelter definition.

The requirement that an excluded transaction be “clearly consistent” with the purposes of the Code differs from the existing section 6662 regulations, which do not include the term “clearly.” This difference imposes a more stringent standard than the existing section 6662 regulations if a transaction is to be excluded from treatment as a tax shelter on this basis. The Recommendation provides for the possibility that additional items may be added to this list by notice or otherwise. An exception is also provided for any matters that are certain to be thoroughly reviewed by the Internal Revenue Service, e.g., advice in connection with a ruling request or an accounting method change, prior to implementation of the transaction.

#### E. Opinions

Under the Recommendation, a tax shelter opinion must address all issues as to which the Service would have a reasonable basis for denial of claimed tax benefits. The reasonable basis standard is the same as the standard under the existing section 6662 regulations, except that in this context the party as to which the standard is applicable is the Service rather than the taxpayer. The reasonable basis standard is based upon the standard set forth in the recent amendment to Treas. Reg. § 1.6011-4T(b)(3)(ii)(C) and is preferable to the standard of

“reasonable possibility of challenge” set forth in section 10.33 of the existing regulations and sections 10.33 and 10.35 of the proposed regulations. The application of the Circular 230 standards for opinions should depend on the substantive nature of the transaction rather than an evaluation of the likelihood of challenge.

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

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

A similar issue can arise with respect to written advice in the development of a transaction as to matters on which a private ruling is later requested from the Service. In this circumstance, the initial written advice should be regarded as subsumed in the ruling request and, therefore, would not be subject to section 10.35.

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

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

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

F. Relationship With Other Sections of Circular 230

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

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

G. Effective Date

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

II. Proposed Amendment to the Circular 230 Regulations

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

## **Section 10.35 Tax shelter.**

(a) (1) Overview— Section 10.35 provides special standards and requirements for the preparation and content of opinions concerning the Federal income tax aspects of a tax shelter (as described in paragraph (b)). However, such requirements do not apply to any opinion with respect to transactions that are designed to result in tax benefits that are clearly consistent with the purposes of applicable Internal Revenue Code provisions. Section 10.35 does not affect the practitioner’s obligation to comply with the standards of conduct prescribed by section 10.34 with respect to opinions provided as a basis for a tax return reporting position.

(2) The standards and requirements for tax shelter opinions are set forth in paragraph (c). Paragraph (d) deals with competence to provide opinions and reliance on opinions of others. Paragraph (e) deals with the effect of an opinion meeting the requirements of section 10.35. Paragraph (f) authorizes the Director of Practice to establish an Advisory Committee with respect to alleged violations of section 10.35.

(b) Definition of a tax shelter. For purposes of this section 10.35, a transaction is a tax shelter if the transaction is described in any of the following paragraphs (1) through (3) and, in the case of paragraphs (2) and (3), is not described in paragraph (4).

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

(2) Principal purpose of tax avoidance or evasion. A transaction is described in this

paragraph (2) if, based on all pertinent facts and circumstances, the principal purpose of the transaction is to avoid or evade Federal income tax. The principal purpose means that purpose exceeds any other purpose. The existence of economic substance does not of itself establish that a transaction does not have the principal purpose of tax avoidance.

(3) Certain transactions having a significant purpose of tax avoidance or evasion. A transaction is described in this paragraph (3) if (A) a significant purpose of the transaction is to avoid or evade Federal income tax, and (B) the transaction has or involves one or more of the following characteristics:

(i) Confidentiality conditions. The practitioner has reason to believe or actual knowledge that the taxpayer has participated in the transaction under conditions of confidentiality (as defined in Treas. Reg. § 301.6111-2T(c)).

(ii) Contractual protection. The practitioner has reason to believe or actual knowledge that the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained, including, but not limited to, rescission rights, the right to a full or partial refund of fees paid to any person, fees that are contingent on the taxpayer's realization of tax benefits from the transaction, insurance protection with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement (other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion of the transaction to the taxpayer).

(iii) Contingent fee. The practitioner receives or is expected to receive a fee (other than a fee based on a reasonable stated hourly rate) that is contingent on the taxpayer's

participation in the transaction or the realization of the anticipated income tax benefits.

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

(v) Practitioner marketing. The transaction is actively marketed or promoted as a tax shelter by the practitioner or the practitioner's firm, as described in paragraph (5)(iv).

(4) (i) Transactions clearly consistent with Code. A transaction is described in this paragraph (4), and therefore is not a tax shelter, notwithstanding that it is described in one or more of paragraphs (2) and (3), if the transaction is structured and effectuated with the objective of claiming exclusions or deferrals of income, tax credits, accelerated deductions or other tax benefits that are clearly consistent with the purposes of applicable provisions of the Internal Revenue Code (as evidenced by relevant statutory language, legislative history, underlying final or temporary Treasury regulations or other published administrative guidance). Examples of transactions that use tax benefits in a manner that may be considered clearly consistent with the purposes of the Internal Revenue Code include (but are not necessarily limited to): providing group term life insurance eligible for the exclusion afforded by section 79, the establishing or maintaining of a plan to defer compensation or provide non-statutory stock options subject to section 83 which insures the matching of related income and deductions; the purchasing or holding of an obligation bearing interest that is excluded from gross income under section 103;

contributing to, paying premiums to, or receiving benefits under an certain accident and health or long-term care plans or medical savings accounts (MSAs) with respect to which sections 105 and 106 provide an income tax exclusion; establishing, maintaining, or contributing to a Medical Savings Account defined by section 220; establishing, maintaining, contributing to, or terminating a cafeteria plan defined by section 125; providing educational assistance through an educational assistance program defined in section 127; establishing, maintaining, contributing to or terminating a dependent care assistance program as defined by section 129; providing certain fringe benefits as defined by section 132; taking an accelerated depreciation allowance under section 168; taking a deduction for a charitable contribution under section 170; taking the percentage depletion allowance under section 613 or section 613A; deducting intangible drilling and development costs as expenses under section 263(c); establishing, maintaining, contributing to, modifying or terminating a qualified retirement plan or IRA under sections 401-409; implementing a multi-employer plan reorganization as defined by section 418 or making contributions thereto, or adjusting accrued benefits thereunder, pursuant to sections 418A-418D; contributing to a welfare benefit fund subject to the contribution and deduction limits of sections 419 and 419A; transferring surplus pension assets to a section 401(h) account as permitted by section 420; establishing, maintaining, contributing to, or terminating a deferred compensation program of a state or local government or tax-exempt organization, as permitted by section 457(b); establishing, maintaining or terminating a trust that is tax-exempt under section 501(a) in connection with a retirement plan that is tax-qualified under sections 401-409; establishing, maintaining, contributing to, or terminating a Voluntary Employees Beneficiary Association defined by section 501(c)(9) or a Supplemental Unemployment Compensation Plan defined by section 501(c)(17); making a contribution to a qualified tuition program under section 529;

claiming the possession tax credit under section 936; claiming tax benefits available by reason of an election under section 851 to be a regulated investment company (“RIC”), an election under section 856 to be treated as a real estate investment trust (“REIT”), an election under section 860D to be treated as a real estate mortgage investment conduit (“REMIC”), an election under section 860L to be treated as a financial asset securitization investment trust (“FASIT”), an election under section 992 to be taxed as a domestic international sales corporation (“DISC”), an election under section 927(f)(1) to be taxed as a foreign sales corporation (“FSC”), or an election under section 1362 to be taxed as an S corporation; selling certain stock to an ESOP and deferring gain thereon pursuant to section 1042; claiming a credit for certain elective deferrals and IRA contributions under section 1042; for nonconventional source fuel under section 29, for qualified research expenses under section 41, or for a low-income housing project under section 42; for contributions made by qualifying small employers to qualifying pension plans under section 45E, for employer-provided child care under section 45F; declining to make a partnership election under section 754; engaging in partnership transactions expressly permitted by Treas. Reg. § 1.701-2; choosing a classification for federal tax purposes under Treas. Reg. § 301.7701-3; engaging in transactions recognized as exchanges under *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991); redeeming partnership interests with property rather than cash; exchanging property under section 1031, including exchanges that are part of a sale of an asset; substituting debt for equity or choosing to issue debt instead of equity; transferring property or a business to a subsidiary; engaging in a reorganization under section 368; or issuing, accepting, exercising, or transferring stock pursuant to an incentive stock option under section 422 or an employee stock purchase plan under section 423. The Internal Revenue Service may identify other transactions as being clearly consistent with the purposes of the Internal Revenue

Code by notice, regulation, or other form of published guidance. The fact that a transaction is clearly consistent with the purposes of the Internal Revenue Code does not necessarily mean that a larger transaction of which it is part is consistent with such purposes. If an opinion excepted from the application of section 10.35 by reason of this paragraph (b)(4) is provided by the practitioner to a taxpayer as a basis for a tax return reporting position, the practitioner must nevertheless satisfy, with respect to such opinion, all of the standards of conduct prescribed by section 10.34.

(ii) Transactions subject to IRS Review. Any transaction that will be subject to review by the Internal Revenue Service prior to implementation by the taxpayer, such as a proposed transaction that is the subject of a private ruling issued by the Service or an accounting method change that is granted by the Service, is not a tax shelter.

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

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

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

(iv) Actively marketed or promoted as a tax shelter. The determination whether a transaction is "actively marketed or promoted as a tax shelter" by the practitioner or the practitioner's firm is based on all of the facts and circumstances, and will be based on the overall marketing or promotional efforts undertaken by the practitioner with respect to the transaction. Facts which may indicate that a transaction is "actively marketed or promoted as a tax shelter" include, but are not limited to, the following actions by the practitioner or the practitioner's firm with respect to that transaction: (a) the development of marketing plans or budgets in connection with the promotion of the transaction; (b) the preparation of marketing or sales materials for the transaction; (c) the distribution of marketing ideas or "talking points" related to the transaction within the practitioner's firm; (d) the preparation and distribution of forms of documents for the transaction; or (e) "sales calls" or similar meetings with clients for the purpose of introducing the clients to the transaction. The preparation and distribution, to one or more existing or potential clients, of a letter or memorandum that describes a potential transaction and the tax benefits that could be obtained by a taxpayer from engaging in such a transaction (whether or not prompted by a recent tax law development) will not cause the transaction to be considered "actively marketed or promoted as a tax shelter" if the letter or memorandum contains an explicit and prominently displayed statement to the effect that (I) the communication is not intended, and may not be relied upon, as professional advice with respect to the Federal income tax consequences of any specific transaction involving the recipient of the communication, and (II) the ultimate Federal income tax consequences of any transaction similar

to the one described in the communication may differ from taxpayer to taxpayer depending upon the particular facts and circumstances. Although the providing of such a letter or memorandum, standing alone, does not give rise to an actively-marketed transaction, all other marketing activities by the practitioner or the practitioner's firm with respect to such transaction must be taken into account in order to determine whether the transaction is actively marketed. A transaction ordinarily will not be considered "actively marketed or promoted as a tax shelter" because a practitioner, in response to client inquiries (including responses to letters or memoranda containing the cautionary language described above), advises multiple clients concerning the Federal income tax consequences of such transaction, even if the advice provided is similar and has a significant purpose of tax avoidance or evasion.

(6) Examples. The following examples illustrate the definition of tax shelter.

Example 1. A practitioner writes a memorandum that evaluates whether a hypothetical taxpayer which enters into a transaction can offset a pre-existing capital gain against certain losses arising from the transaction. The practitioner concludes that, while the principal purpose for entering into the transaction is the avoidance or evasion of Federal income tax within the meaning of paragraph (b)(2) (and that the transaction is not described in the exception of paragraph (b)(4) as clearly consistent with the Code), there is a realistic possibility (or higher level of confidence) that the tax loss arising from the transaction is the proper treatment. The practitioner plans to provide this memorandum directly to one or more existing or prospective clients who have capital gains. The memorandum is a tax shelter opinion for purposes of this section. The memorandum would still be a tax shelter opinion if it were instead provided in response to a specific client request for tax advice regarding such a transaction.

Example 2. The facts are the same as in Example 1, except that the practitioner concludes that the transaction has a significant (rather than the principal) purpose of avoidance of Federal income tax, and the memorandum is also provided by other members of the practitioner's firm to existing or prospective clients. The practitioner and the practitioner's firm actively market or promote the transaction to clients within the meaning of paragraph (b)(5)(iv). The transaction is not described in subparagraphs (i), (ii), (iii) or (iv) of paragraph (b)(3). The memorandum is a tax shelter opinion for purposes of this section 10.35 unless the desired tax consequences of the transaction are clearly consistent with the purposes of the Internal Revenue Code as contemplated by paragraph (b)(4).

Example 3. A practitioner prepares a memorandum describing a recent decision by the United States Supreme Court and advising clients to review their own tax situations in order to determine if the case applies to them. The memorandum bears a legend similar to that set forth in paragraph (b)(5)(iv). No other marketing activities relating to a transaction similar to the one involved in the Supreme court decision are conducted by the practitioner or the practitioner's firm. The memorandum is not a tax shelter opinion.

Example 4. The facts are the same as in Example 3, except that the memorandum describes a hypothetical transaction that is somewhat different than the transaction involved in the Supreme Court decision and suggests that, based on certain language in the decision, such a transaction would have a reasonable possibility (or higher level of confidence) of yielding very favorable tax consequences. The transaction described has a significant purpose of tax avoidance and is not clearly consistent with the purposes of the Internal Revenue Code. The preparation and distribution of the memorandum does not constitute active marketing or

promotion of a tax shelter within the meaning of paragraph (b)(5)(iv). However, notwithstanding the inclusion of a cautionary legend and the absence of any other marketing or promotional activity, the memorandum could still be a tax shelter opinion if any of the characteristics described in subparagraphs (i)-(iv) of paragraph (b)(3) were present.

Example 5. A practitioner prepares a memorandum describing a hypothetical transaction that has a significant purpose of tax avoidance and is not clearly consistent with the purposes of the Internal Revenue Code. The memorandum is provided by the practitioner to a person (other than a member of the practitioner's firm) that will use or refer to the opinion (or the practitioner or the practitioner's firm) in promoting or marketing the transaction. The memorandum is a tax shelter opinion because it is described in paragraph (b)(3)(iv).

Example 6. A practitioner prepares a memorandum for a client explaining a tax planning strategy, and the client has agreed not to disclose the memorandum or the tax planning strategy to any other person. The desired tax consequences of the strategy are not clearly consistent with the purposes of the Internal Revenue Code as contemplated by paragraph (b)(4), and although avoidance of Federal income tax is not the principal purpose of the transaction, it is a significant purpose of the transaction. Because the transaction is recommended under conditions of confidentiality, the memorandum is a tax shelter opinion.

Example 7. A practitioner is requested by a client to prepare a memorandum evaluating whether the purported Federal tax treatment of a tax loss arising from a transaction will be sustained if challenged by the Internal Revenue Service. The desired tax consequences of the transaction are not clearly consistent with the purposes of the Internal Revenue Code as contemplated by paragraph (b)(4). Tax avoidance is not the principal purpose of the transaction

but is a significant purpose of the transaction. The practitioner has reason to know that the client will pay a fee to the practitioner that is contingent upon the amount of tax savings to the client, depending upon whether the reported loss is sustained if challenged. The memorandum is a tax shelter opinion.

Example 8. The facts are the same as in Example 7, except that the fee to be paid to the practitioner is a fixed amount that will be paid in all events. The memorandum is not a tax shelter opinion.

Example 9. The practitioner prepares a memorandum for a client with respect to a transaction a significant purpose of which is the avoidance or evasion of Federal income tax and that is not clearly consistent with the purposes of the Internal Revenue Code as contemplated by paragraph (b)(4). The transaction is not described in subparagraphs (i), (ii), (iv) or (v) of paragraph (b)(3). The practitioner's fee is a flat fee that is not based upon a reasonable hourly rate. The practitioner's fee will not be paid if the transaction does not occur. Because the practitioner's fee is contingent, the memorandum is a tax shelter opinion.

Example 10. The facts are the same as in Example 9, except that the fee, which will not be paid if the transaction does not occur, is based upon reasonable stated hourly rates. A fee that is based upon reasonable stated hourly rates cannot constitute a "contingent fee" within the meaning of paragraph (b)(2)(iii). Therefore, the memorandum is not a tax shelter opinion.

Example 11. A law firm prepares a memorandum for distribution to clients describing how the firm's clients may receive tax benefits from engaging in a transaction a significant purpose of which is the avoidance or evasion of federal income tax and that is not

clearly consistent with the purposes of the Internal Revenue Code as contemplated by paragraph (b)(4). The transaction is not described in subparagraphs (i), (ii), (iii) or (iv) of paragraph (b)(3). The memorandum is accompanied by copies of the "form" agreements needed to implement the transaction. The law firm sends an electronic message to all of its partners and associates, describing the transaction, the types of clients for which the transaction might be appropriate, and "talking points" that can be used in connection with the promotion of the transaction. Members of the law firm are urged to call clients and arrange meetings to discuss the possibility of the clients participating in this or a substantially similar transaction. Because the transaction is "actively marketed or promoted as a tax shelter" within the meaning of paragraph (b)(5)(iv), the memorandum is a tax shelter opinion.

(c) Compliance requirements. A practitioner who provides a tax shelter opinion must comply with each of the following requirements with respect to the opinion.

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

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

(A) A factual assumption that the practitioner knows or has reason to

believe is incorrect, incomplete, inconsistent with an important fact or another factual assumption, or implausible in any material respect; or

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

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

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

a transaction is potentially profitable apart from tax benefits without providing adequate factual support. In addition, a valuation is inconsistent with a material fact or factual assumption or is implausible if it appears to be based on facts that are inconsistent with the facts of the transaction.

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

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

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

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

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

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

(i) The opinion must clearly identify the facts upon which the opinion's

conclusions are based.

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

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

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

(3) Evaluation of material Federal tax issues and overall conclusion. The practitioner must clearly state in the opinion his or her conclusion as to the likelihood that an investor (or, where the practitioner is relying on a representation as to the characteristics of

potential investors, a typical investor of the type to whom the transaction is or will be marketed) will prevail on the merits with respect to each material Federal tax issue that involves a reasonable basis for denial of the claimed tax benefits. This requirement is not satisfied by including a statement in the opinion that the practitioner was unable to opine with respect to certain material Federal tax issues, including but not limited to whether the transaction has a business purpose or economic substance.

(i) The opinion must either –

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

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

(ii) In ascertaining that all material Federal tax issues have been considered and that all which involve a reasonable basis for denial of the claimed tax benefits have been fully and fairly addressed, and in evaluating the merits of those issues and evaluating whether the Federal tax treatment of the tax item or items is the proper tax treatment, the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.

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

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

(6) Financial forecasts and projections. A practitioner who makes a report with financial forecasts or projections relating to or based on the tax consequences of items that are included in written materials disseminated to any or all of the same persons as the opinion of another practitioner may rely on the opinion as to any or all material Federal tax issues, provided

that the practitioner who desires to rely on the other opinion (i) does not have reason to believe or actual knowledge that the practitioner rendering such other opinion has not complied with the standards of paragraph (c), (ii) is satisfied that the other practitioner is sufficiently knowledgeable, and (iii) does not know and has no reason to believe that the opinion of the other practitioner should not be relied on. The practitioner's report must disclose any material Federal tax issue not covered by, or incorrectly opined on, by the other opinion, and shall set forth his or her opinion with respect to each such issue in a manner that satisfies the requirements of paragraph (c).

(d) Effect of opinion that meets compliance requirements. An opinion of a practitioner that meets the requirements of paragraph (c) will satisfy the practitioner's responsibilities under this section 10.35, but the persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion will be separately determined under applicable provisions of the law and regulations.

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