COMMENTS ON PROPOSED RULEMAKING
CIRCULAR 230
ABA SECTION OF TAXATION

February 12, 2004

The views expressed herein are presented on behalf of the Section of Taxation (the “Section”). These comments have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association. ¹

The Section regularly has commented on proposed revisions to Circular 230. Most recently the Section commented extensively on April 23, 2001, August 13, 2001 and April 24, 2002. The Section enjoys a long and rich history as a leader in matters involving the improvement of the tax system by regulating the conduct of practitioners pursuant to Circular 230. The Tax Section first proposed rules governing tax shelter opinions nearly 25 years ago, leading the American Bar Association to issue Opinion 346, which was largely incorporated into Circular 230 as Section 10.33. Because Section 10.33 would be repealed by the proposal, and replaced by new Section 10.35, the Tax Section has a keen interest in assuring a comprehensive and effective transition.

¹ The comments were prepared by a Joint Task Force Committee on Standards of Tax Practice and the Tax Shelter Task Force of the Section. Members of the Joint Task Force were Frederic L. Ballard, Jr., Dennis B. Drapkin, Miriam L. Fisher, Steve R. Johnson, Phillip L. Mann, Ronald A. Pearlman, Charles A. Pulaski, and Paul J. Sax. Principal drafting responsibility was exercised by Paul J. Sax and reviewed by Michael B. Lang, Chair of the Committee of Standards of Tax Practice; Herbert N. Beller, Council Director for the Tax Shelter Task Force; Mark L. Yecies, Council Director for the Standards of Tax Practice Committee; and Richard A. Shaw, Chair of the Section. Although many of the members of the Section who have participated in preparing these comments have clients that would be affected by the principles addressed by these comments or have advised clients in the application of said 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 these comments.
The Section is pleased to be able to supply these comments within the short response period that was provided. In view of the difficulty of some of the questions we address below, we intend to continue our consideration, and look forward to such additional communications as time permits.

**SUMMARY**

The Section welcomes the proposed rulemaking. The statements included as “best practices” for tax advisors are a useful addition to practice guidelines. To avoid misuse, it should be made clear that the statement of “best practices” is aspirational and that the “best practices” are not intended to state minimum standards of conduct intended to be enforced.

The Section strongly believes that in addition to such guidelines, rules stating minimum standards of conduct are necessary. It is important that such rules be enforceable and that in fact they be enforced.

We believe that it is essential that rules applicable to “more likely than not tax shelter opinions” apply only to formal opinions. Application of the rules to informal advice would burden and disrupt traditional tax planning advice to the detriment of the tax system, by discouraging taxpayers from requesting (and practitioners from providing) written advice.

The opinion requirements that are proposed to apply to certain tax shelter opinions are reasonable and follow logically from the experience with Section 10.33. There is a proper role for exempting from the requirements limited opinions and advice reasonably expected to be followed by an opinion, and we offer clarifications that we hope will be helpful. We believe, however, that the proposal requires modification so as not to allow self-marketing of limited opinions free of the requirements that are proposed to apply to certain tax shelter opinions. Failure to address this serious potential gap in coverage of the proposal could have serious
consequences, as it could lead to a return to the limited opinion abuses of the 1970’s that were corrected in the provisions of Section 10.33 of Circular 230 that would be repealed by the proposal.

We oppose the proposed delegation of authority to practitioner members of the Advisory Committee to single out other practitioners for discipline. Such a delegation has a prohibitive potential for abuse and error.

**Best Practices.** We welcome the articulation of best practices for tax advisors set forth in proposed Section 10.33(a). We note that the best practices in their most general form are derivative of the American Bar Association Model Rules of Professional Conduct, including Rule 1.1, The Duty of Competence; Rule 1.2, Scope of Representation; Rule 2.3, Evaluation for Use by Third Person; Rule 3.4, Fairness to Opposing Party and Counsel; and Rule 5.1, Responsibilities of a Partner or Supervisory Lawyer. More specifically, the American Bar Association has issued Formal Opinions addressing application to tax practice, including Opinion 314 delineating the relationship between lawyers and the Internal Revenue Service, Opinion 346 prohibiting forms of limited opinion in tax shelter opinions to non-clients adopted in Section 10.33 of Circular 230, and Opinion 85-352 stating the minimum standard for asserting a position in a tax return adopted in Section 10.34 of Circular 230.

The list of best practices makes no reference to applicable professional standards. Nor does the best practices list include reference to practicing competently (the proposal opinion requirements specifically impose a duty of competence, in proposed section 10.35(b)(1)). We suggest the addition of new paragraph (a)(7), as follows: “Practicing competently and otherwise in accordance with the principles and guidelines recognized by the practitioner’s profession.”

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In any statement of best practices we believe that it is important to be clear that best practices are solely aspirational. Otherwise the statement is vulnerable to misuse, by mischaracterizing what is intended as an aspirational guideline as a minimum standard of conduct. We encourage inclusion of a specific recitation that the best practices do not constitute minimum standards of conduct intended to be enforced. We recommend substituting the “endeavor” for “take reasonable steps” in the first sentence of paragraph 10.36(a), and adding the following sentence at the end of that paragraph: “Evidence that a practitioner has endeavored to comply with procedures of the type contemplated by this paragraph (a) will be considered to be in substantial mitigation in any case in which a violation of paragraph (b) may have occurred.”

We do not intend to diminish the value of a statement of best practices. There is value to such a statement, properly done, and we welcome it. But in today’s circumstances aspirational standards cannot be a substitute for rules that can be enforced, and that are enforced. The Section strongly believes that there is no substitute for rules in today’s tax shelter context, and welcomes requirements that practitioners must follow.

We advocate the adoption of rules because they are necessary to end practices that we view as damaging to the tax system, even though those practices have been engaged in by only a relatively small number of firms. We believe that the vast majority of our members understand and abide by the principles embodied in the statement of best practices. But the adverse effect of untoward opinion practices by some on the administration of the tax system, in our view, mandates the action represented by the proposal.

**Requirements For Certain Tax Shelter Opinions.** As applied to formal tax opinions, the requirements that apply to “more likely than not tax shelter opinions” and “marketed tax shelter opinions” are reasonable and fair. We view them as essentially applying the requirements
of Opinion 346, as incorporated in existing Section 10.33 applicable to third party tax shelter opinions. We make only a few suggestions in the interest of clarity.

Subparagraph (a)(1)(ii) should be clarified to provide that, although a practitioner rendering a marketed tax shelter opinion is not expected to identify or ascertain facts peculiar to the taxpayer to whom the transaction is marketed, the facts that the practitioner is not expected to identify relate to the taxpayer’s particular tax status, such as a PHC, CFC, REIT and the like. Our concern is that the sentence could be read to qualify the remainder of subparagraph (a)(2)(ii), in which event marketed tax shelter opinions would be exempted from the proposed prohibition against assuming the transaction has a business purpose or is potentially profitable apart from tax benefits. Under no circumstance should a practitioner rendering a marketed tax shelter opinion be allowed “to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits, or to make an assumption with respect to a material valuation issue.” The ambiguity might be remedied by stating that in the case of any marketed tax shelter opinion the practitioner is not “otherwise” expected to identify or ascertain facts peculiar to a taxpayer, and by stating explicitly that a practitioner rendering a marketed tax shelter opinion may not indulge such assumptions.

In subparagraph (a)(3)(iv) practitioners are foreclosed from taking into account the possibility that a return will not be audited, an issue will not be raised on audit, or that an issue will be settled, in providing opinions on material tax issues. It should be made clear that this requirement applies also to the overall conclusion described in subparagraph (a)(4), such that the overall conclusion also must address the merits rather than the vagaries of the audit selection and settlement process.
Subparagraph (b) allows the practitioner to rely upon the opinion of another practitioner only if the practitioner is not sufficiently knowledgeable to render an informed opinion with respect to the material federal tax issue. This precludes a practitioner from sharing responsibility with another practitioner for any reason other than a lack of knowledge, even though all issues are addressed by a practitioner and an overall conclusion is reached. We view this as a reasonable requirement, but submit that it also would be reasonable to allow a practitioner who is knowledgeable with respect to all issues to involve another practitioner on a discrete issue, provided that in the aggregate all requirements are met.

**Limited Opinions.** The concept of the limited scope opinion is helpful but may prove difficult to apply in practice. We concur that the required disclosure should be stated “at the beginning of the opinion” and that it should be recited that the opinion cannot be used by the recipient to avoid the substantial understatement penalty as to issues outside the scope of the opinion. To eliminate all doubt, it should be explicitly stated that limited opinions need not provide the overall conclusion required by paragraph (a)(4). We agree with the approach of the proposal to preclude the use of limited opinions in the context of tax shelter marketing - the “marketed tax shelter opinion.”

However, we further believe there is great potential for abuse inherent in the use of limited opinions. We recall that Opinion 346 and Section 10.33 were written as a direct response to the abuses represented by limited opinions given to third parties in the context of tax shelters marketed to non-client investors in the 1970’s. The “reasonable basis” opinion, the “hypothetical facts” opinion, and the “memorandum of law” that discussed issues but drew no conclusion were all forms of limited opinion. The abuses are well chronicled. Taking history as a guide, the use of limited opinions should be very carefully circumscribed, as discussed below,
by specifically subjecting all “self-marketed” opinions to the coverage and diligence requirements of Section 10.35.

The concept of limited opinions does not alter the need, discussed below, to limit application of the proposal to “more likely than not tax shelter opinions” that are formal tax opinions, in order to avoid unwanted application to traditional forms of tax planning advice. The proposal requires that a practitioner rendering a limited opinion ascertain the actual facts, relate the law to those facts, recite the agreed-upon limitation of scope, make specific disclosures as to reliance for penalty protection, and make specific disclosures as to the existence of certain arrangements. Compliance with these requirements is often wholly impractical in the context of informal advice. Taken together these requirements greatly diminish the practical utility of the limited opinion concept to the extent it was intended to provide a general exception for informal advice.

“More Likely Than Not Tax Shelter Opinions.” We agree with the approach of the proposal to impose the tax shelter opinion requirements on “more likely than not tax shelter opinions”. Such opinions are assumed by investors to offer at least some level of penalty protection, even though absent compliance with the proposed requirements (that they address all material tax issues, relate the law to the actual facts, and draw an overall conclusion) they would offer little if any such protection. We caution, however, that absent a carefully drawn definition of “more likely than not tax shelter opinion” that excludes advice of an informal nature, the proposal could have unintended consequences, placing impossible burdens on traditional tax planning advice necessary to the functioning of our tax system, and deterring taxpayers from seeking advice they need.
Excluded Advice. The proposed rulemaking provides that excluded advice consists of written tax advice that is expected subsequently to be followed by written advice that satisfies the requirements. To avoid abuse, it should be required not only that there be such an expectation in fact, but that the expectation that written advice will subsequently be provided be “reasonable” as evidenced by objective facts. A pattern of alleged but failed such expectations would render the claimed expectations unreasonable. The regulatory exception should be available whether the subsequent advice is expected to be provided by the practitioner or by another.

We note also that advice concerning the qualification of a qualified plan is excluded advice, an exclusion that we welcome. There are other potential exclusions that we believe have merit, as we have discussed in prior comments. Advice that will be subject to review by the Internal Revenue Service prior to implementation, such as advice that a proposed transaction that is the subject of a private letter ruling issued by the Service or an accounting method change that is approved by the Service, should be an excluded opinion. Advice in SEC registered offerings should be considered for exclusion, by reason of SEC review. An opinion that interest is excludable from income under Section 103 of the Code should be excluded, by reason of the relatively higher standard of certainty embodied in opinions as to the issuance or remarketing of state and local government obligations. Consideration should be given to more expansive exclusion in an “angel list” of tax-favored transactions, excluding opinions in categories that the Service agrees are rarely the subject of abuse (such as those enumerated in Treas. Reg. §1.6662-4(g)(2)(ii)).

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2 We are concerned that failure to exempt these opinions ultimately would lead to a degradation of “Section 103” opinions. This is not to say there are no abuses in “Section 103 opinions.” Rather, our concern is that such opinions would, in the guise of compliance with the rule requiring that material tax issues be addressed, be used to put transactions onto the market that would not be approved under present standards.
**Marketed Tax Shelter Opinion.** We note the application of the opinion requirements to “marketed tax shelter opinions,” using a definition that is the same as that proposed in our comments of April 24, 2002. At that time, however, we also proposed that opinions be subjected to these requirements if any of a number of other factors were met, including one determined by reference to the payment of fees that targeted marketed tax shelters. As proposed, the definition of marketed tax shelter opinion would not include self-marketed tax shelter opinions.

Experience reveals that many abusive tax shelter transactions have been self-marketed. Exempting such opinions from the requirements of the proposal would lead to assertions that the proposal does more to encourage, than to stem, abusive tax shelter activity.

We understand the difficulty of determining when a self-marketed tax shelter opinion should be subject to the requirements of the proposal. This asks the question of when an “idea memorandum” shown to a client should be required to address all material issues, relate the law to the facts and draw an overall conclusion.

We previously urged that certain tests or indicators be used to subject opinions to the opinion requirements, such as the presence of conditions of confidentiality, a principal purpose of tax avoidance, contractual protections against liability and a fee arrangement not reasonably related to reasonable hourly rates. We understand the difficulty of applying those rules, and accept that the proposal has chosen not to adopt them.

Nonetheless, by allowing limited opinions and exempting self-marketing of opinions other than “more likely than not” opinions, a path is laid for a return to pre-Opinion 346 practices in which opinions were widely employed that stated only a reasonable basis for the position rather than stating any prospect for success, opinions that assumed facts that could not be true, and opinions that discussed issues but drew no conclusions. Such opinions rarely, if ever, would
afford any basis for penalty protection. Nonetheless, based upon both history and an understanding of practices today, we know that such opinions can be widely and successfully used in marketing. The reason is that tax opinions are not used solely to provide penalty protection. Instead, the fact of the association of a professional reputation of a law firm or a large multidisciplinary professional services firm lends legitimacy to the transaction which is important in the investment process, whether in the boardroom, or to the chief financial officer, or to an individual investor. The fact of association with the transaction by such a firm is taken in the marketplace as an imprimatur and speaks more loudly to investors than a lengthy substantive law discourse in the opinion.

As discussed above, we have previously suggested a variety of indicators that can be used to determine when an opinion should be subjected to the requirements included in the proposal. Perhaps an even more fitting and comprehensive solution than the use of such indicators would be to include in the definition of “marketed tax shelter opinion” any tax shelter opinion that is actively marketed, whether by the practitioners who prepared it, the practitioner’s own firm or others. To that end we recommend that paragraph (c)(6) be amended to read as follows: “A marketed tax shelter opinion is a tax shelter opinion that the practitioner knows or has reason to know will be used or referred to in marketing the tax shelter.” We find both useful symmetry and desirable common sense in treating any opinion that is in fact actively marketed as a “marketed tax shelter opinion.”

We appreciate that there may be uncertainty inherent in what is marketing and what is not. One obvious remedy to uncertainty is, when in doubt, to comply with the opinion requirements. In addition, the proposal might draw from our prior comments of August 13, 2001 to explain that an opinion is not considered marketed solely because the practitioner or the
practitioner’s firm sends clients a letter or memorandum informing them of new developments or
tax planning opportunities, or provides similar tax planning advice to multiple clients solely in
response to the clients’ requests for assistance. All facts and circumstances would be taken into
account, including activities by the practitioner, the practitioner’s firm and others, to determine if
the activities with respect to the transaction constitute marketing. Consideration also could be
given to a conclusive presumption that marketing has occurred when substantially the same
advice has been given to three or more clients that did not initiate the request for assistance.
Client inquiries that have been solicited as part of the marketing effort would be disregarded for
this purpose. Useful reference may be made to the securities law experience and concepts used
in determining if a series of ostensibly unrelated private placements constitute an integrated
public offering, where there is industry acceptance of reference to relevant facts and
circumstances in determining application of securities regulations.

Definitions. In order for the proposal to regulate tax shelter opinion practices without
undue burden on the preponderance of ordinary written tax advice, it is essential that the term
“more likely than not tax shelter opinion” include only formal opinions. This should be done in
a way that is certain and unambiguous. The term should be limited to written opinions that on
their face provide formal advice of a type that usually is rendered only on the final and complete
form of a transaction.

Practitioners are deeply concerned that the term “more likely than not tax shelter
opinion” might be read to encompass any written advice, however informal, that expressly or
implicitly states a conclusion as to particular tax consequences that does or could be interpreted
to indicate a “more likely than not” or higher level of confidence. Such advice is an essential
part of many written communications that comprise traditional tax planning of ordinary business
transactions. Like a formal opinion, such tax planning advice is intended to be relied upon, but only in a way appropriate to the circumstances, and rarely for penalty protection. Often it addresses alternatives, or is hypothetical, or preliminary, or merely describes what the law is. Were the proposal to apply to such forms of advice, serious adverse consequences to the tax system would result, in that clients would either have to pay for costly and less quickly delivered formal advice that they did not feel was necessary or, more likely, would be deterred from obtaining the basic advice they need to comply with the tax law.

If no way can be found to differentiate formal opinions from lesser forms of written advice, alternatives should be considered. For example, it may be possible to distinguish pre-transactional planning advice, where the rules would apply only to formal opinions, from advice not given prior to (or in connection with) consummation of the transaction, which presumptively may be viewed as issued for penalty protection purposes and therefore more broadly subjected to the proposed rules.

Another alternative may be to conform these rules with applicable penalty regulations, such that penalty protection would be afforded only by an opinion bearing a legend stating that the opinion was intended to be relied upon for purposes of penalty protection, and which otherwise complied with these proposed rules. An advantage of such an approach is that it would relieve the pressure now placed by the proposal by the combination of the broad definition of “tax shelter” to include a “significant purpose” of tax avoidance or evasion and the potential for including informal advice as a “more likely than not tax shelter opinion.” On the other hand, this approach might be of limited effectiveness, because it is not clear that it would (or should) preclude taxpayers from asserting that opinions not complying with the rules should be taken into account in assessing the taxpayer’s reasonable cause and good faith.
We therefore urge that, as finalized, the regulations unambiguously limit “more likely
than not tax shelter opinions” to formal written advice that purports to be the opinion of the
practitioner or firm, of a type which ordinarily addresses the final and complete form of a transaction. Such a limitation need not apply to “marketed tax shelter opinions,” where the threat to the system represented by active marketing of tax products justifies additional burdens, and history reflects a potential for abuse in forms of advice other than formal opinions.

We previously suggested that a material tax issue be defined as one as to which the Service position enjoyed a “realistic possibility of success.” The proposal lowers the standard to “reasonable basis.” We understand the desire to broaden the category of material tax issues required to be addressed. But if “reasonable basis” is to be employed the meaning of the term should be further clarified. The reason that Opinion 85-352 was issued later was and adopted in Section 10.34 was that “reasonable basis” had come to have different meanings, requiring restatement in the form of the “realistic possibility of success” standard, which per Regulation section 1.6694-2(b)(1) implies an approximately one in three or greater likelihood of success. The definition of “reasonable basis” in Regulation section 1.6662-3(b)(3) has the effect of narrowing the uncertainty but is nonetheless vague. One solution would be to state that a position has a “reasonable basis” if it enjoys an approximately one in five likelihood of success on the merits.

The definition of “tax shelter opinion” requires written advice. It should be made clear that advice is written advice even though it is communicated only electronically.

The definition of “tax shelter item” might be expanded to address employment tax concepts such as inclusion in “wages.” Application to employment taxes appears intended, as the definition of tax shelter reaches any tax imposed by the Internal Revenue Code.
We agree that an opinion should be included even if the name of the practitioner or the practitioner’s firm is not referred to in the offering materials or in connection with the sales promotion efforts. Likewise, we agree that the requirements should apply where the practitioner is an officer or employee of the taxpayer.

**Disclosures.** We agree with the proposed disclosures required to be made with respect to fee sharing arrangements and referral arrangements. But we question whether there is a need to require disclosure of customary fee arrangements; no useful purpose is served by requiring a recitation at the beginning of the opinion that the author was compensated at its regular and usual hourly rates for the time employed or otherwise in accordance with industry custom and practice.

**Procedures To Ensure Compliance.** In addition to the necessary conforming amendment to section 10.52, Treasury should make clear in the preamble to the final regulations, or through other published guidance, that discipline will not lie for isolated, technical failures to comply, or for good faith misinterpretations of the rules. Practitioners ought not have the slightest reason to fear that they could be subjected to the cost and burden of defending a charge of violating Circular 230 merely by reason of unintentional misapplication of these rules.

We welcome the inclusion of rules applicable to persons having responsibility for a firm’s tax practice. We note that the rule for persons having responsibility applies only to practitioners who have “principal” authority and responsibility for overseeing a firm’s practice. That is too narrowly limited, to the extent principal means of “first importance.” The rules should not be limited to the topmost person in a large professional organization, but rather made applicable to practitioners who have supervisory authority and responsibility. We submit that ABA Model Rule of Professional Conduct 5.1, Responsibilities of a Partner or Supervisory Lawyer, would be useful as a guide. Individual practitioners having supervisory responsibility
should be subject to discipline if they fail to take reasonable steps to assure compliance, if that
failure is willful, reckless or through gross incompetence as provided in Section 10.52.

Some believe that Treasury should give serious consideration to strengthening the proposal by providing for appropriate sanctions against firms that fail to take reasonable steps to have and maintain policies and procedures that assure compliance with these rules, and whose members engage in a pattern or practice of violations. They assert that it is the firm that enjoys the financial benefits of improper opinion practices, and concomitantly, it is the firm which should be given a strong incentive to assure compliance with the proposed rules. Others believe that authority for firmwide discipline not only puts at risk practitioners wholly unrelated to any offense, but gives rise to a prohibitive risk of abuse in actual application. Particularly in the case of smaller firms, the mere threat may be sufficient to obtain acquiescence in a position no matter how wrong or unjustified the firm may believe that position to be. All agree that any such sanctions should be measured fairly against the offense, and that because the mere threat of firmwide suspension may have draconian consequences, it should be provided that, except in extraordinary circumstances, the sanction appropriate to an entire firm would be in the form of private or public censure or reprimand, not suspension or disbarment. Given the significant division of views on the subject, we do not make a specific recommendation.

**Advisory Committee.** We note in Section 10.37(a) the suggestion that there be an advisory committee. This has long been a provision in Section 10.33(d). However, the proposal would have the advisory committee make recommendations regarding “whether a practitioner” may have violated Section 10.35 and 10.36. That is a new concept. We view it as appropriate for an advisory committee to make recommendations of general application. But absent an extraordinary circumstance, members of an advisory committee would not be positioned
appropriately to conduct examinations or investigations sufficient to warrant recommendations for individual discipline. There is prohibitive potential for conflicts of interest, abuse and error inherent in some practitioners singling out others for discipline by the Service. We strongly urge that such responsibility is better undertaken by the Director of Practice and the professional personnel of the Director’s office.

**Effective Date.** We recommend that the final proposal not be made effective until at least thirty days after publication, in order to avoid disruption to pending transactions and offerings in circulation.