TESTIMONY

OF

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CHAIR OF THE

AMERICAN BAR ASSOCIATION SECTION OF TAXATION

ON

REGULATIONS GOVERNING PRACTICE

BEFORE THE

INTERNAL REVENUE SERVICE

FEBRUARY 19, 2004
Testimony on Circular 230

Good morning. My name is Richard A. Shaw. I appear today in my capacity as Chair of the American Bar Association Section of Taxation. These comments are made on behalf of the Section of Taxation. They have not been approved by the House of Delegates or Board of Governors of the American Bar Association and should not be considered as Association policy.

The ABA Section of Taxation appreciates the opportunity to appear today to discuss important issues raised in the proposed amendments to Circular 230. In the limited time I have before you, I would like to highlight some of the significant considerations that were submitted as part of our formal comments on the proposals last week.

The ABA and the Tax Section have been leaders in proposing rules governing tax shelter opinions since first releasing its Formal Opinion 346, which was largely incorporated into Circular 230. The Section has strongly recommended that the Treasury Department update and revise Circular 230 to provide clear, definitive and enforceable guidelines.

**Best Practices**

We welcome the inclusion of best practices for tax advisors as set forth in proposed Section 10.33(a). These best practices are consistent with, and in general form, derivative of the American Bar Association Model Rules of Professional Conduct and ABA Formal Opinions addressing the application of these rules to tax shelters. We encourage their inclusion and recommend that they be expanded to endorse a standard for practicing competently, consistent with principles recognized by the practitioner's own profession.
In view of the promotion for "highest quality representation," we suggest that the rules be clarified to indicate that best practices are solely aspirational, and are not intended as a minimum standard of conduct.

We strongly also endorse the establishment of required conditions for drafting tax shelter opinions that can and should be enforced.

**Requirements for Certain Tax Shelter Opinions**

As applied to formal tax opinions, the requirements that apply in preparing “more likely than not tax shelter opinions” and/or “marketed tax shelter opinions” are reasonable. They should and do require that the tax practitioner exercise due diligence in ascertaining the facts, relating the law to the facts, and requiring a proper evaluation of material federal tax issues.

We view them as essentially applying the requirements of ABA Formal Opinion 346, as incorporated into Section 10.33 applicable to third party tax shelter opinions. Our written comments have made some technical suggestions in the interest of clarity.

**Limited Tax Shelter Opinions**

The concept of a limited scope tax opinion is somewhat helpful but may prove difficult to apply. In this instance, the practitioner, with the consent of the client, opines as to specific issues and must understand that the opinion does not avoid penalties with respect to any issues outside the scope of the opinion. The proposal requires that the practitioner rendering a limited opinion apply the general standards for ascertaining the actual facts, relating the law to the facts, and then reciting the limitation of the scope of the opinion.
Some concern exists that uncertain scope of limited opinions may open the door to abuse similar to that occurring in the 1970s, where opinions frequently relied upon "hypothetical" statements of fact. To the extent that the limited opinion concept is intended as an alternative to permitting informal tax advice, it may be impracticable.

**More Likely Than Not Tax Shelter Opinions**

Members of the Tax Section continue to have great difficulty with a definition of a "tax shelter" for Circular 230 purposes that is so broad that it includes any plan or arrangement where a significant purpose of any tax item is the avoidance of taxation. The standard opens the barn door for any aggressive revenue agent to assert penalties on a simple, defective S election or like-kind exchange, where the taxpayer has not provided a comprehensive tax opinion containing all the elements of these proposals.

Practitioners in small firms frequently give quick email advice to specific inquiries from clients who are not able to pay for a full-blown tax opinion on a simple plan designed to reduce taxes, such as the adoption of a medical reimbursement plan for employees (§ 213).

Suppose a small-town attorney advises a client in an email that when she contributes property to a new corporation she will not have a tax if property transfers have 80% control under Section 351. Has the client lost penalty protection because there is an informal "should" or "will" tax opinion that is higher than a more likely than not opinion? This is a tax shelter under the definition and a significant purpose is tax reduction.

While the requirements of Section 10.35 are appropriate for formal opinions intended to offer at least some level of penalty protection, we strongly recommend that the
proposed rules be clarified to avoid unwanted application of traditional informal forms of tax planning advice. If the rules are not so clarified, the rules could have a significant, adverse, unintended consequence of placing impossible burdens on traditional tax planning and informal communication and advice between client and practitioner that is necessary for the functioning of our tax system.

It would deter taxpayers from seeking the formal advice that they need to assure compliance with their tax obligations.

Thus, the definition of a "more likely than not tax shelter opinion" should be limited to formal opinions that on their face provide formal advice of a type that is usually rendered only in the final and complete form of a transaction. Likewise, that "significant purpose" concept deserves some explanation.

**Expanded Advice**

Consideration should be given to a more expanded definition of “excluded advice” that would exclude opinions in categories that the Service agrees are rarely subject to abuse. Our written comments note several potential exclusions that should be included, such as transactions subject to Private Letter Rulings or changes in methods of accounting that are subject to IRS approval prior to implementation, and advice in offerings registered with the Securities and Exchange Commission. In addition, the Service should be given explicit authority to specify additional exclusions through an “angel list” of tax-favored transactions.
**Marketed Tax Shelter Opinions**

We also believe that the proposed definition of a “marketed tax shelter opinion” should be revised to include self-marketed transactions. As proposed, the definition of a marketed tax shelter opinion does not include a tax shelter opinion prepared and marketed within the same organization. Experience reveals that many abusive tax shelter transactions have been so self-marketed. Exempting such opinions from the requirements of the proposal would lead to assertions that the proposal does more to encourage a large avenue of potential abusive tax shelter activity.

The rules should apply to any tax shelter opinion that is actively marketed, whether by the practitioner who prepared it, the practitioner’s own firm, or by third parties.

**Reasonable Basis – Federal Tax Issues**

Our comments also discuss other specific definitions. The proposal would require attention to any federal tax issue for which the Service has a "reasonable" basis for a successful challenge, when the resolution would have a significant impact on the tax treatment of the item.

We previously suggested and continue to recommend that a material tax issue be defined as one in which the Service enjoys a "realistic possibility of success," or at least a "one in three chance of success." However, if a "reasonable basis" is to be employed, then additional guidance as to the definition of "reasonable basis" would be helpful. A solution suggested by some is that the position of reasonable basis be defined as approximately a one-in-four, or a one-in-five likelihood of success on the merits.
Procedures to Ensure Compliance

The rules should be made clear that discipline will not lie for isolated, technical failures to comply, or for good faith misinterpretations of the rules. Practitioners ought not to have the slightest reason to fear that they will be subjected to the cost and burden of defending a charge of violating Circular 230, merely by reason of an unintentional misapplication of these rules.

We welcome the addition of Section 10.36, placing responsibilities on practitioners who have principal authority and responsibility for overseeing a firm’s tax practice to ensure that the firm has adequate procedures for compliance with Section 10.35.

The rules should be clear that they are not limited to the topmost person, such as in a large professional organization, but rather should be also applied to other practitioners who have supervisory authority and responsibility. We have recommended that you give attention to ABA Model Rule of Professional Conduct, Section 5.1, "Responsibilities of a Partner or Supervisory Lawyer." Supervisors should also be subject to discipline if they fail to take reasonable steps to assure compliance based on their willful or reckless conduct or gross incompetence.

Advisory Committee

We concur that an advisory committee can play a useful role in reviewing and making recommendations regarding professional standards or best practices for tax advisors. However, it does not seem consistent with the status of an "advisory" committee that it should be placed in the position of making specific inquiries as to whether a particular practitioner may have violated the rules of Sections 10.35 or 10.36.
There is a prohibitive potential for conflicts of interest, abuse, or errors inherent in some practitioners being singled out by others to cause discipline by the Service. This is a responsibility better preserved and exercised by the Director of the Office of Professional Responsibility and the staff professionals under the Director's guidance.

**Effective Date**

We recommended that the final rules not be made effective until at least thirty days after publication, and recommend a longer period, in order to avoid disruption in pending transactions and offerings then in circulation.

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We hope that the foregoing observations as well as the more detailed comments contained in our written submission will be of assistance to you as you undertake the difficult task of finalizing these rules. Considering the complexity and importance of the professional responsibility guidelines contained therein, you may wish to release additional proposed comments, rather than rely upon final or temporary regulations having immediate affect.