Ethics

Section 10.27 of Circular 230: What Is Left?

By Karen L. Hawkins

On July 16, 2014, a federal district judge permanently enjoined the IRS Office of Professional Responsibility (OPR) from enforcing certain aspects of the “Fees” provision contained in Circular 230. In doing so, the court concluded that the IRS lacked “statutory authority to promulgate or enforce the restrictions on contingent fee arrangements, as delineated in 31 C.F.R. §10.27, with respect to the preparation and filing of Ordinary Refund Claims, where ‘preparation and filing’ precedes the inception of any examination or adjudication of the refund claim by the IRS and any formal legal representation on the part of the practitioner.” (Emphasis added.) Since the regulation has not been amended to reflect the court’s order, this column discusses what is left for OPR to enforce and what practitioners might be able to do, or not do, under current law.

As most practitioners are aware, many of the ethical principles contained in Circular 230 are fashioned after the ABA Model Rules of Professional Conduct (hereafter “Model Rules”). The Fees provision is one example of this. Because fee arrangements of any sort have always been perceived as creating some level of conflict of interest between lawyer and client, the ABA historically has had some interest in regulating this aspect of the attorney-client relationship. While many of those who provide services in the tax context are not lawyers, the IRS clearly holds to the same general notion that the fee aspects of the practitioner-client relationship harbor the potential for creating conflicts of interest because it is primarily the tax practitioner who determines the fee and the manner of performance based on an analysis of the time and resources expected to be devoted to the services rendered and the desired “return on that investment.” This conflict is exacerbated in the contingent fee context, where the practitioner acquires an economic interest in his or her client’s tax matter(s). The arrangement clearly has the potential to cloud the practitioner’s professional judgment. And, because the usual concept of risk-sharing that obviates some of the conflict concerns in the general law does not exist with tax law, the “risk,” rather than being shared between practitioner and client, is borne almost entirely by the tax agency which must “catch” the collaborative efforts of a taxpayer and his or her advisor to reduce tax liability in a manner contrary to intended law.
Unconscionable Fees

The contingent fee restriction contained in section 10.27 is just one aspect of that regulation. Prior to 1994, the Fees provision in Circular 230 was dominated by a general prohibition against “unconscionable fees” for “representation” in any matter before the IRS. An exception existed for amended returns and claims for refund/credit so long as “the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended tax return or refund claim will receive substantive review by the Internal Revenue Service.” The regulation has always been silent as to what constitutes an “unconscionable fee.” Presumably, the regulation drafters contemplated guidance coming from the Comments to the Model Rules.

The prohibition on unconscionable fees remains in the current version of Circular 230, unaffected by recent case law such as Ridgley, with one significant wording change from 1994: “A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service.” A matter before the IRS is defined at 10.27(c)(2) to include “tax planning and advice, preparing or filing … or assisting in preparing or filing returns, claims for refund or credit, and all matters connected with a presentation to the IRS … relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the IRS.”

What constitutes an “unconscionable fee”? Model Rule 1.5(a) admonishes against entering into agreement that charges an unreasonable fee or charges an unreasonable amount for expenses. The rule delineates eight nonexclusive factors to consider when determining whether a fee is unreasonable:

1. the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
2. the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
3. the fee customarily charged in the locality for similar legal services;
4. the amount involved and the results obtained;
5. the time limitations imposed by the client or by the circumstances;
6. the nature and length of the professional relationship with the client;
7. the experience, reputation, and ability of the lawyer or lawyers performing the services; and
8. whether the fee is fixed or contingent.

Presumably unreasonable fees or excess charges in ABA parlance equate to an “unconscionable fee” in “IRS-speak.” An “unconscionable fee” is often “in the eye of the beholder.” One practitioner’s outsized hourly rate is another’s standard operating procedure. In the world of discipline, however, there is at least one instance when a fee is always “unreasonable” or “unconscionable”: when money is taken and no services are performed. From that far end of the spectrum, all else is facts and circumstances driven by market conditions. Comment (2) to Model Rule 1.5 puts it this way:

When the lawyer has regularly represented a client, they ordinarily will have evolved an understanding concerning the basis or rate of the fee and the expenses for which the client will be responsible. In a new client-lawyer relationship, however, an understanding as to fees and expenses must be promptly established. Generally, it is desirable to furnish the client with at least a simple memorandum or copy of the lawyer’s customary fee arrangements that states the general nature of the legal services to be provided, the basis, rate or total amount of the fee and whether and to what extent the client will be responsible for any costs, expenses or disbursements in the course of the representation. A written statement concerning the terms of the engagement reduces the possibility of misunderstanding. (Emphasis added.)

Whatever the challenges to proving a particular fee is “unconscionable,” the reality for tax practitioners going forward is that the concept of unreasonable fees and excess charges remains a viable line of inquiry for OPR and for discipline under Circular 230. This should include an inquiry as to whether a particular fee arrangement, including a contingent fee arrangement, is reasonable (or unconscionable) in the context of the specific tax services being contracted for.

Contingent Fees

While the Ridgley court enjoined future enforcement against practitioners using contingent fee agreements in
the context of the mere preparation of "ordinary refund claims," it did not specifically address such fee structures in the context of preparing or filing original returns, claims for credit, tax advising or planning or other tax practice activities. What aspects of the contingent fee provision in Circular 230 are still viable, and which have questionable validity, notwithstanding the IRS's current failure to conform the language in the regulation to reflect current judicial interpretation?

Generally, the language still extant in section 10.27(b)(1) prohibits contingent fees in the context of "any matter" before the IRS, as defined at 10.27(c)(1). Section 10.27(c) defines a contingent fee as one which is based in some part on whether or not a position taken either in a tax return or other filing escapes an IRS challenge, or if challenged, is ultimately sustained administratively or judicially. It also includes the more traditional notion of a contingent fee—one based on a percentage of a refund, taxes saved or a specific economic result obtained. Further, a contingent fee agreement can include one which requires the practitioner to reimburse the client fee in some proportion if an IRS challenge occurs, or if a position is not administratively or judicially sustained when challenged. The Model Rule does not define a contingent fee specifically, but it does require a contingent fee arrangement to be in a writing which clearly identifies the terms and conditions for provision of the services to be rendered. Comment (3) to Model Rule 1.5 contains the observation that local law may impose additional restrictions and reminds lawyers that the fee is still subject to the general "reasonableness" standard and the eight factors listed in MR 1.5(a). It is reasonable to expect that federal judges before whom any future disciplinary actions for violations of section 10.27 are brought will look to the principles contained in Model Rule 1.5 for guidance.

Section 10.27(b)(2) lists exceptions to the general prohibition against contingent fees: 1) in connection with an IRS examination of, or challenge to, an original return or an amended return/claim for refund or credit; 2) claims for credits/refunds related to statutory interest or penalties; 3) whistleblower actions; and 3) judicial proceedings. So, even under the existing language of section 10.27, contingent fees are permissible in pre-assessment administrative controversy practice, i.e., situations where the IRS is examining, or otherwise challenging, an original tax return or an amended tax return or claim for refund/credit: situations the Ridgley court would likely define as both adversarial and requiring a power of attorney from the taxpayer to the practitioner to authorize the representation.

In often-overlooked Notice (2008-43), the IRS clarified the 120-day rule associated with charging contingent fees in the context of amended returns and claims for refund/credit by stating that contingent fees were permissible "for services rendered in connection with the [IRS'] examination of, or challenge to":

An amended return or claim for refund or credit filed before the taxpayer received a written notice of examination of, or a written challenge to, the original tax return; or filed no later than 120 days after the receipt of such written notice or written challenge. The 120 days is computed from the earlier of a written notice of the examination, if any, or a written challenge to the original return.

Notice 2008-43 stated the Treasury's intention to amend section 10.27(b) to reflect this clarification the next time the Circular was amended. Despite proposing and finalizing amendments to Circular 230 in 2011 and 2014, this clarifying language has never found its way into section 10.27(b). Such a focused clarifying amendment seems like a needless exercise at this point, unless the IRS intends to try to regulate contingent fees in contested cases where the amended return or claim for refund/credit is filed more than 120 days after taxpayer receives an IRS notice of examination or other written challenge to an original return.

There is one context in which the current state of the law regarding contingent fees appears to have remained intact: services performed in connection with IRS collection activity.

Ridgley clearly deregulates contingent fees in the context of preemptive claims for refund, i.e., those which are initiated by the taxpayer (and, of course the advising representative) before any involvement by the IRS. The Loving case legacy makes it clear that those who provide mere tax return preparation are outside the scope of the OPR regulatory authority entirely. Is it not then a logical conclusion after Ridgley that those who, regardless of licensure status, charge a contingent fee for merely preparing an original tax return cannot be prohibited from doing so by Circular 230, unless they are otherwise "practicing" before the IRS?

The Loving/Ridgley combination opens up a whole panoply of services for which tax professionals (whether
considered practitioners or not) may now propose contingent fee arrangements, judged only by the broad “unconscionable fee” prohibition at section 10.27(a). Any exceptions carved out by the regulations at section 10.27(b)(2)(i), (ii), (iii) are largely irrelevant because the general rule has been “swallowed” by the current case law. The manner in which a contingent fee arrangement can be structured will be confined only by the creativity of the practitioner proposing such an arrangement (or by the client who prefers it) and, arguably, by the reasonableness of using a contingent fee agreement at all under a specific set of facts and circumstances.

What Is Left?

There is one context in which the current state of the law regarding contingent fees appears to have remained intact: services performed in connection with IRS collection activity. The existing regulation carved out exceptions for services performed during administrative proceedings in connection with examinations and challenges to returns and claims for refund or credit. The case law reinforces the concept that a “practitioner” who is representing before the IRS pursuant to a power of attorney IS subject to Circular 230. The general rule still is that a contingent fee may not be charged (except in the context of regulatory or judicially-created exceptions) “in connection with any matter before the Internal Revenue Service.” (Emphasis added.) Such matters include “all matters connected with a presentation to the IRS … relating to a taxpayer’s rights, privileges, or liabilities under laws or regulations administered by the IRS.” The currently enjoined existing regulation contemplated exceptions only for services performed in connection with examinations of, or challenges to, original or amended returns and claims for refund/credit. Both of the judicially-created exceptions for mere tax return and ordinary refund claim preparation are premised on the lack of “representation” activity. While a preparer of returns/claims, whether original or subsequent iterations, has no legal authority to bind the taxpayer or act on the taxpayer’s behalf, and therefore is not “practicing” before the IRS, a practitioner communicating with the IRS in an effort to reduce a tax liability or arrange for an alternative method of collection has clearly been authorized, at a minimum, to speak on the taxpayer’s behalf.

Collection activity involves a very different phase of IRS interaction. It does not constitute the examination of, or challenge to, returns or claims for refund/credit. If collection activity is occurring, the challenges/examinations are concluded, and a debt has been recorded. Representation in the context of IRS collection action involves preparing and/or presenting financial information and documentation with respect to a taxpayer’s liabilities (and perhaps rights and privileges under the laws administered by the IRS) and requires the submission of a power of attorney. The taxpayer hires the representative to speak on his or her behalf and to negotiate with the IRS about an assessed tax debt. The context is adversarial. The holder of the power of attorney becomes a “representative” “practicing” before the IRS and subject to Circular 230 in its entirety. A practitioner providing services under a contingent fee agreement for such representation has no regulatory or judicial exceptions available and will be in violation of both the general rule against unconscionable fees, and the specific prohibition on contingent fees, contained in section 10.27.

There is a second context in which contingent fee prohibitions are questionable under the current state of the law: services involving written tax advice, the result of which finds its way onto a tax return or claim for refund. If the mere preparer of an original tax return or an ordinary refund/credit claim is no longer constrained under section 10.27(b), what is the basis for prohibiting tax professionals, who advise on the positions being taken in those documents, from entering into contingent fee agreements with the taxpayer, subject only to the unconscionable fee prohibition in section 10.27(a)?

Conclusion

Subject to a general prohibition on unconscionable fees, the current rules on contingent fee agreements for services in tax cases can be summarized as follows:

1. Mere preparation of original returns—arguably allowable under the combined reasoning of Loving and Ridgley
2. Services in connection with examinations/challenges to original returns—allowed under section 10.27(b)(2)(i)
3. Mere preparation of ordinary claims for refund or credit—allowed under Ridgley
4. Services in connection with examinations/challenges to amended original tax returns or amended claims for refund or credit—allowed under section 10.27(b)(2)(ii) as clarified by Notice 2008-43. There is an open
question if the amendment occurs more than 120 days after the IRS issues the notice of examination or other challenge.

5. Services in connection with claims for credit/refund of statutory penalties or interest—allowed under section 10.27(b)(3)

6. Services in connection with whistleblower claims under Code Sec. 7623—allowed under section 10.27(4) as added by Notice 2008-43

7. Services in connection with any judicial proceeding arising under the Code—allowed under section 10.27(5) as renumbered by Notice 2008-43

8. Services involved with giving written tax advice—arguably allowed under the combined reasoning of Loving and Ridgley

It is clear the law of fees in tax cases is not through evolving. It is equally clear that there is no dearth of tax practitioners prepared to pick over the skeletal remains of section 10.27 to limit even further its future applicability.

ENDNOTES

1. Treasury Department Circular 230, 31 CFR Subtitle A, Part 10 (Rev 6-2014), section 10.27. Hereafter, all references are to “Circular 230” and the 2014 version except where noted otherwise.


3. A thought-provoking article on Ridgley’s effect on reportable transactions by Charles R. Markham appeared in the JTPP issue for October–November, 2015. Charles R. Markham, Life After Ridgley: While Some Contingency Fee Restrictions Have Been Lifted, Practitioners Should Be Mindful That Reportable Transaction Rules Apply, J. TAX PRACTICE AND PROCEDURE, Oct.–Nov. 2015, at 57. This author expresses no opinion on that piece.

4. See ABA Model Rule 1.8 clarified by Model Rule 1.5—attorneys are prohibited from acquiring a proprietary interest in their client’s litigation, except where the fee agreement is reasonable and fair, not otherwise prohibited by the Rules or other law (domestic relations matters and criminal defense), and the agreement, stating the methodology for computing the fee, is in writing.

5. Prior language read “for representing a client in a matter before the [IRS].”

6. Section 10.27(a). (Emphasis added.)

7. The last phrase in this definition tracks precisely the language used to define “Practice” at section 10.2(a)(4).

8. Model Rule 1.5(a).

9. Defined by the court in Ridgley to mean claims for refund initiated after the filing of an original return and before any IRS-initiated activity challenging the return.

10. The Model Rule flatly prohibits contingent fees in domestic relations and criminal matters. It also specifically identifies as “local law” “government regulation regarding fees in certain tax cases.”

11. Cir. 230, section 10.27(b)(2) as clarified by Notice 2008-43.


14. Mr. Ridgley is a CPA. The court rejected the government’s argument that this status subjected Ridgley to Circular 230 for all tax practice activities.

15. S. Loving, CA-DC, 2014-1 ustc ¶50,175, 742 F3d 1013. This case has been addressed extensively in the past two years obviating the need for detailed discussion in this column.


17. The regulation acknowledges an exception for “judicial proceedings arising under the Internal Revenue Code” (see section 10.27(5)) but is silent with respect to administrative proceedings under the Code for collection of a tax liability.

18. Section 10.27(c)(2).

19. Whether the “mere” preparation of a Form 433 will be shielded under a Loving analysis remains to be seen, but this writer believes proceeding with such an assumption is unwarranted.

20. Individuals who are not otherwise subject to the regulations as practitioners become so through other provisions once the Form 2848 is submitted. See section 10.7(c) and Rev. Proc. 81-38, 1981-2 CB 592. The revenue procedure is almost impossible to find and has been posted for ease of access on the OPR pages of IRS.GOV.

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