

**CIRCULAR 230
AND
TAX SHELTERS
IN 2009[©]**

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CIRCULAR 230 AND TAX SHELTERS IN 2009*

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I. TAX SHELTER REGULATIONS

A. Overview

- Disclosure requirements for participants in “reportable transactions.”
- List-maintenance requirements for “material advisors” with respect to reportable transactions.
- Disclosure requirements for “material advisors” with respect to transactions.¹

II. TAX SHELTER DISCLOSURE REQUIREMENTS FOR PARTICIPANTS

A. Overview

- Categories of Reportable Transactions²

* The authors are grateful to Karen Gilbreath and David Miller for their contributions to an earlier version of this outline and to Stanley Barsky for his excellent update.

¹ On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (the “JOBS Act”), which substantially increased the penalties and sanctions for failing to comply with the tax shelter regulations. In addition, the JOBS Act repealed the tax shelter registration requirements and created new reporting requirements for material advisors.

² The fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer’s treatment of the transaction is proper. Treas. Reg. § 1.6011-4(a).

- Listed Transactions
- Confidential Transactions
- Loss Transactions
- Contractual Protection Transactions
- Transactions of Interest entered into on or after November 2, 2006
- Patented Transactions would constitute a new category of reportable transaction under proposed regulations.³
- Participant Reporting Obligations
 - Every taxpayer “participating” in a reportable transaction that is required to file a U.S. tax return must:⁴
 - Mail IRS Form 8886 to the IRS Office of Tax Shelter Analysis for the first year the taxpayer participates in the transaction,
 - Attach IRS Form 8886 to its tax return (and any amended return) for each year in which the taxpayer participates in the transaction,⁵ and
 - Retain a copy of all documents and other records related to the reportable transaction

³ Prop. Treas. Reg. § 1.6011-4(b)(7), 72 Fed. Reg. 54615 (Sept. 25, 2007).

⁴ Treas. Reg. § 1.6011-4(a), (d).

⁵ If a reportable transaction results in a loss which is carried back to a prior year, the disclosure statement for the reportable transaction must be attached to the taxpayer’s application for tentative refund or amended tax return for that prior year. Treas. Reg. § 1.6011-4(e)(1).

In addition, the taxpayer must include the “reportable transaction number” received from material advisors with respect to the transaction on the Form 8886. Treas. Reg. § 1.6011-4(d).

that are material to an understanding of the tax treatment and tax structure of the transaction until the statute of limitations runs.⁶ However, taxpayers are not required to retain non-substantive emails and other documents that are not material to the tax treatment or tax structure of the transaction. Taxpayers are also not required to retain earlier drafts of a document if the taxpayer retains a copy of the final document (or, absent a final document, the most recent draft of the document), and such final document (or most recent draft) contains all the information found in earlier drafts that is material to an understanding of the purported tax treatment or tax structure of the transaction.⁷

- A taxpayer's failure to properly disclose a reportable transaction is a strong indication that the taxpayer did not act in good faith with respect to the transaction for purposes of the general reasonable cause and good faith exception to the accuracy related penalty.⁸ Moreover, a taxpayer that has not adequately disclosed a reportable transaction in accordance with the tax shelter regulations may not rely on

⁶ Treas. Reg. § 1.6011-4(g). The term "transaction" includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of a plan. Treas. Reg. § 1.6011-4(b)(1).

The documents may include (i) marketing materials related to the transaction, (ii) written analyses used in transaction related decision-making, (iii) transaction related correspondence and agreements between the taxpayer and any advisor, lender, or other party to the reportable transaction, (iv) documents discussing, referring to, or demonstrating the purported or claimed tax benefits arising from the reportable transaction, and (v) any documents referring to the business purposes for the reportable transaction. Treas. Reg. § 1.6011-4(g).

⁷ Treas. Reg. § 1.6011-4(g).

⁸ Treas. Reg. § 1.6664-4(d).

the adequate disclosure exception to the accuracy related penalty for disregard of rules and regulations.⁹ Finally, the regulations deny the “realistic possibility” defense for a taxpayer that disregards a revenue ruling or notice with respect to a reportable transaction.¹⁰

- If a taxpayer requests a ruling on the merits of a specific transaction on or before the date disclosure would otherwise be required, and receives a favorable ruling as to the transaction, the disclosure rules will be satisfied if the ruling request fully discloses all relevant facts relating to the transaction which would otherwise be required to be disclosed.¹¹
- If a taxpayer requests a ruling as to whether a specific transaction is a reportable transaction on or before the date that disclosure would otherwise be required, the IRS commissioner in his discretion may determine that the request satisfies the disclosure rules if the ruling request fully discloses all relevant facts relating to the transaction which would otherwise be required to be disclosed.¹²
- A protective disclosure filed with respect to a potentially reportable transaction that complies with all disclosure requirements would satisfy a taxpayer’s potential obligation to disclose the transaction.¹³
- However, the taxpayer’s potential disclosure obligation is not suspended while the ruling request is pending.¹⁴

⁹ Treas. Reg. § 1.6662-3(a).

¹⁰ Treas. Reg. § 1.6662-3(a).

¹¹ Treas. Reg. § 1.6011-4(f)(1).

¹² Treas. Reg. § 1.6011-4(f)(1).

¹³ Treas. Reg. § 1.6011-4(f)(2).

¹⁴ Treas. Reg. § 1.6011-4(f)(1).

- In the case of a taxpayer who is a partner in a partnership, a shareholder in an S corporation, or a beneficiary of a trust, the disclosure statement must be attached to the entity's return for each taxable year in which the entity participates in a reportable transaction.¹⁵
- If a taxpayer receives a timely Schedule K-1 less than 10 calendar days before the due date of the taxpayer's return (including extensions), the taxpayer must file the disclosure statement with OTSA within 60 calendar days after the due date of the taxpayer's return (including extensions).¹⁶
- If a transaction becomes a listed transaction or a transaction of interest after the filing of a taxpayer's return (including an amended return), but before the end of the period of limitations for the taxpayer's final return reflecting the listed transaction, the taxpayer must file a disclosure statement with OTSA within 90 calendar days after the date on which the transaction became a listed transaction or transaction of interest.¹⁷
- If a transaction becomes a loss transaction because the losses equal or exceed the threshold amounts, a disclosure statement must be filed as an attachment to the taxpayer's tax return for the first taxable year in which the threshold amount is reached and to any subsequent tax returns that reflect any amount of loss from the transaction.¹⁸

B. Listed Transactions

- A listed transaction is defined as any transaction the IRS designates as a tax avoidance transaction and identifies in published guidance as a listed

¹⁵ Treas. Reg. § 1.6011-4(e)(1).

¹⁶ Treas. Reg. § 1.6011-4(e)(1).

¹⁷ Treas. Reg. § 1.6011-4(e)(2)(i).

¹⁸ Treas. Reg. § 1.6011-4(e)(2)(ii).

transaction (and any “substantially similar” transaction).¹⁹

- A “substantially similar” transaction is any transaction that is either factually similar or based on the same or similar tax strategy as a transaction described in published guidance and is expected to obtain the same or similar types of tax consequences. The regulations provide that the term “substantially similar” must be broadly construed in favor of disclosure. Receipt of an opinion concluding that the tax benefits from the taxpayer’s transaction are allowable is disregarded in determining whether the taxpayer’s transaction is the same as, or substantially similar to, a listed transaction.²⁰
- A taxpayer “participates” in a listed transaction if the taxpayer’s tax return reflects tax consequences or a tax strategy associated with a listed transaction (or the taxpayer “knows or has reason to know” that its tax benefits are derived directly or indirectly from a listed transaction).²¹ “Tax benefits” include any deduction, deferral, basis adjustment, or any other tax return achieved by affecting the amount, timing, character, or source of any item of income, gain, expense, loss, or credit.²²

C. Confidential Transactions

- Prior regulations broadly defined a confidential transaction to include any transaction offered to a taxpayer under conditions of confidentiality, but also presumed that a transaction was not a

¹⁹ Treas. Reg. § 1.6011-4(b)(2).

²⁰ Treas. Reg. § 1.6011-4(c)(4). The regulations also contain examples of transactions that are the same or substantially similar to listed transactions.

²¹ Treas. Reg. § 1.6011-4(c)(3)(i)(A).

²² Treas. Reg. § 1.6011-4(c)(5); Treas. Reg. § 1.6011-4(c)(6).

confidential transaction if the transaction documents contained a “tax confidentiality waiver.”²³

- In response to significant criticism regarding the breadth of the confidential category of reportable transactions,²⁴ the IRS issued regulations in 2004 which significantly narrowed the definition of a confidential transaction.²⁵ The regulations issued in August, 2007 contain a virtually identical definition of confidential transactions.²⁶
- A transaction is not treated as a confidential reportable transaction solely by reason of confidentiality limitations imposed by a

²³ Treas. Reg. § 1.6011-4(b)(3) (revised Dec. 29, 2003).

Our standard tax confidentiality waiver provided as follows:

Notwithstanding anything to the contrary contained in this Agreement, all persons may disclose to any and all persons, without limitations of any kind, the U.S. federal, state or local tax treatment of the Transaction, any fact that may be relevant to understanding the U.S. federal, state or local tax treatment of the Transaction, and all materials of any kind (including opinions or other tax analyses) relating to such U.S. federal, state or local tax treatment, other than the name of the parties or any other person named herein, or information that would permit identification of the parties or such other persons, and any pricing terms or other nonpublic business or financial information that is unrelated to the U.S. federal, state or local tax treatment of the Transaction to the taxpayer and is not relevant to understanding the U.S. federal, state or local tax treatment of the Transaction to the taxpayer.

²⁴ See e.g., *Bond Market Association’s Comments on the Final Tax Shelter Regulations*, 2003 TNT 108-16 (June 5, 2003).

²⁵ For comments addressing the revisions to the confidentiality provisions, see N.Y. St. B.A. Tax Sec., *Comments on Disclosure Regulations*, 2004 TNT 33-18 (Feb. 18, 2004); Udrys, Reeder and Church, *The Revised Confidentiality Filter: Top 12 Practical Implications*, 2004 TNT 46-8 (Mar. 8, 2004).

²⁶ Treas. Reg. § 1.6011-4(b)(3). The principal change from the 2004 regulations appears to be the addition of a statement that the government will closely scrutinize all of the facts and circumstances to determine whether consideration received in connection with a confidential transaction constitutes fees.

principal to a transaction acting as such.²⁷

Instead, a transaction is treated as a confidential reportable transaction only if (i) an “advisor” limits the taxpayer’s ability to disclose the tax treatment, or the tax structure, of the transaction, (ii) the advisor imposing the limitation is paid a fee of at least \$50,000 (\$250,000 if the taxpayer is a corporation or a partnership or trust with solely corporate owners or beneficiaries), and (iii) the limitation on disclosure protects the confidentiality of the advisor’s “tax strategies.”²⁸

- Query: What is a “tax strategy”? For example, government representatives have observed that a tax strategy may include routine statements made in tax disclosure, or made to principals (*e.g.*, a partnership will be treated as a partnership for tax purposes).
- Because the term “advisor” is not defined in the regulations and has the potential to be interpreted quite broadly, many law firms and financial intermediaries continue to include tax confidentiality waivers in their documents to ensure non-confidentiality.
- Query: What is an “advisor”? Presumably an advisor includes any attorney, accountant, investment banker, or other individual that is paid a fee for advice regarding a “tax strategy.” Can it include a principal who discusses a tax strategy that affects deal pricing with other parties?

²⁷ T.D. 9108, 2004-1 C.B. 429.

²⁸ Treas. Reg. § 1.6011-4(b)(3). The “tax treatment” of a transaction is the purported or claimed federal income tax treatment of the transaction, and the “tax structure” of a transaction is any fact that may be relevant to understanding the tax treatment of the transaction. Treas. Reg. § 1.6011-4(c)(8), (9).

The regulations do not define the terms “tax strategies” or “tax advisor.”

- Query: Will some or all fees received by an advisor that also participates in the transaction as a principal be considered received in that person's capacity as principal?²⁹ Will a specific allocation of fees be respected? When will a person with two roles be treated as imposing confidentiality as an advisor rather than as a principal?
- A proprietary or exclusive transaction will not be treated as confidential if the advisor confirms to the taxpayer that there is no limitation on disclosure of the tax treatment or tax structure of the transaction.³⁰
- Query: What does it mean to "impose" confidentiality by limiting disclosure? Government representatives have agreed that if an advisor confirms to the taxpayer that there is "no limitation on disclosure of the tax treatment or tax structure of the transaction, other than limitations imposed by the SEC, other regulatory bodies, or under the law," that confirmation should satisfy the regulations since the advisor has only referenced (but has not personally imposed) third party limitations on such disclosure.

²⁹ The regulations provide that:

. . . all fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a transaction are taken into account A fee does not include amounts paid to a person, including an advisor, in that person's capacity as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property. Treas. Reg. § 1.6011-4(b)(3)(iv).

Corresponding revisions were made to the material advisor fee requirements of the tax shelter listing regulations.

³⁰ Treas. Reg. § 1.6011-4(b)(3)(ii).

- Query: What result obtains if an advisor imposes confidentiality on an opposing principal party, but not on its own client acting as a principal?
- Query: If an advisor permits the disclosure of the tax treatment and tax structure of a transaction, but imposes confidentiality on all other facts, including, for example, the advisor's investment strategy, will the transaction be considered confidential for purposes of the regulations?
- Query: Does a limitation on opinion reliance (*e.g.*, only the addressee is permitted to rely) constitute confidentiality?
- Query: Will confidentiality imposed by an advisor for only a limited period of time, *i.e.*, during initial negotiations, now cause a transaction to be considered confidential?
- Ordinary course transactions such as debt and equity offerings, cash purchases and sales of stock and assets, and executive compensation arrangements should not be considered confidential transactions reportable by the participants, because they do not involve tax advice provided for a fee by an advisor imposing confidentiality. This result should obtain even if the tax consequences of such a transaction are set forth in disclosure, as long as no fee is paid for advice regarding a tax strategy. However, more complicated transactions, including certain M&A deals, joint ventures, and investment fund offerings, may include advisory fees (including fees embedded in returns paid to principals) and if so, those transactions should also include confidentiality waivers.
- Persons treated as related parties under section 267(b) or section 707(b) are treated as the same

person for the purposes of confidential transaction rules.³¹

D. Loss Transactions

- A loss transaction is defined as any transaction that results in a loss under section 165 of at least:³²
 - \$10 million in a single year or \$20 million in any combination of years for corporations and partnerships (all of whose partners are corporations).
 - \$2 million in a single year or \$4 million in any combination of years for all other taxpayers.
 - \$50,000 in any single year for individuals or trusts that recognize a section 988 foreign currency loss.
- A taxpayer participates in a loss transaction if the taxpayer's tax return reflects a section 165 loss equal to or greater than the applicable threshold.³³ In determining whether a transaction results in a loss that equals a threshold, only losses claimed in the first taxable year the transaction occurs and the five succeeding taxable years are combined.³⁴

³¹ Treas. Reg. § 1.6011-4(b)(3)(v).

³² Treas. Reg. § 1.6011-4(b)(5)(i)(A)-(E).

³³ Treas. Reg. § 1.6011-4(c)(3)(i)(D).

³⁴ Treas. Reg. § 1.6011-4(b)(5)(ii). In addition, in determining whether a transaction results in a loss that equals a threshold, loss amounts are adjusted for any salvage value, insurance or other compensation received, but are not adjusted to reflect offsetting gains, or other income or limitations. The full amount of a loss is taken into account for the year in which the loss is sustained, regardless of whether all or part of the loss creates a net operating loss or a net capital loss that is carried back or carried over to another year. A loss does not include any portion of a loss attributable to a capital loss carryback or carryover from another year that is treated as a deemed capital loss. However, a loss does include an amount deductible pursuant to a provision that treats a transaction as a sale or

- A safe harbor excepts transactions involving assets in which the taxpayer has “qualifying basis.”³⁵
 - The safe harbor is not available if the asset is an interest in a “pass-through entity” other than regular interests in a REMIC (*e.g.*, partnerships, PFIC and FPHC equity interests, and REMIC residual interests).³⁶
- Revenue Procedure 2004-66 exempts certain other losses.³⁷

other disposition, or otherwise results in a deduction under section 165. Treas. Reg. § 1.6011-4(b)(5)(iii).

³⁵ Rev. Proc. 2004-66, 2004-2 C.B. 966. A taxpayer has “qualifying basis” in an asset only if the basis of the asset is equal to, and is determined solely by reference to, the amount (including any option premium) paid in cash by the taxpayer to acquire or improve the asset. A taxpayer also has qualifying basis if the basis of the asset is (i) determined under section 358 by reason of it being received in an exchange to which section 354, 355, or 361 applies, and the taxpayer had qualifying basis in the property exchanged, (ii) determined under section 1014, (iii) determined under section 1015, and the donor had qualifying basis, (iv) determined under section 1031(d), the taxpayer had qualifying basis in the property exchanged and any debt instrument issued or assumed by the taxpayer in exchange is treated as a payment in cash, (v) adjusted under section 961 or section 1.1502-32, and the taxpayer had qualifying basis in the asset immediately prior to the adjustment, or (vi) adjusted under section 1272(d)(2) or section 1278(b)(4), and the taxpayer had qualifying basis in the asset immediately prior to the adjustment. In addition, an amount included as compensation income under section 83 will be treated as an amount paid in cash by the taxpayer for an asset if the amount is included in the taxpayer’s basis in the asset. Rev. Proc. 2004-66, 2004-2 C.B. 966.

³⁶ The safe harbor is also not available if (i) the loss from the sale or exchange of the asset is an ordinary foreign currency loss, (ii) the asset has been separated from any portion of the income it generates, or (iii) the asset is or has in the past been part of a straddle, other than a mixed straddle under Temporary Regulation section 1.1092(b)-4T. Rev. Proc. 2004-66, 2004-2 C.B. 966.

³⁷ See Rev. Proc. 2004-66, 2004-2 C.B. 966. Revenue Procedure 2004-66 modifies and supersedes Revenue Procedure 2003-24, 2003-1 C.B. 599.

E. Contractual Protection Transactions

- Contractual protection transactions include any transaction for which:³⁸
 - The taxpayer has the right to a full or partial refund of fees paid to a tax advisor if some or all of the intended tax consequences from the transaction are not sustained,³⁹ or
 - The tax advisor's fees are contingent on the taxpayer's realization of the tax benefits from the transaction.⁴⁰
- A taxpayer participates in a contractual protection transaction if the taxpayer's tax return reflects a tax benefit from the transaction and the taxpayer has the right to a refund of fees paid or the taxpayer's obligation to pay fees is contingent.⁴¹
- Transactions in which a refundable or contingent fee is related to certain tax credits will not be considered contractual protection transactions unless the transaction qualifies as a reportable transaction under another category of reportable transaction.⁴²

³⁸ Treas. Reg. § 1.6011-4(b)(4).

³⁹ Treas. Reg. § 1.6011-4(b)(4)(i). This provision also applies if the party entitled to a refund is related to taxpayer within the meaning of section 267(b) or section 707(b).

⁴⁰ The regulations provide that refundable or contingent fees will not be taken into account in determining whether the transaction has contractual protection if the statement is made after the taxpayer has entered into and reported the transaction on a filed tax return, and the person making the statement has not previously received fees from the taxpayer relating to the transaction. Treas. Reg. § 1.6011-4(b)(4)(iii)(B). This exception permits an attorney to receive contingent fees with respect to a tax controversy without causing the underlying transaction to be a reportable transaction.

⁴¹ Treas. Reg. § 1.6011-4(c)(3)(i)(C).

⁴² Rev. Proc. 2007-20, 2007-7 I.R.B. 517. More specifically, transactions in which a fee is refundable or contingent shall not be

F. Transactions of Interest

- Regulations proposed in November, 2006 and finalized in August, 2007, added “transactions of interest” as a new category of reportable transactions.⁴³
- The regulations define a transaction of interest as a transaction that is the same as, or substantially similar to, one of the types of transactions that the IRS identifies by notice, regulation, or other form of published guidance as a transaction of interest.⁴⁴
- The preambles to the proposed and final regulation describe a transaction of interest as a transaction that the IRS and Treasury Department believe has a potential for tax avoidance or evasion, but for which they lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction.⁴⁵ Accordingly, the regulations permit the IRS to gather information regarding transactions of interest without treating the transaction as a listed transaction.
- Transactions of interest will be identified in published guidance,⁴⁶ and a taxpayer will be considered to have participated in a transaction of interest if the taxpayer is one of the types or classes

considered a contractual protection transaction if the transaction is related to the: (i) work opportunity credit under section 51, (ii) welfare-to-work credit under section 51A, (iii) Indian employment credit under section 45A, (iv) low-income housing credit under section 42(a), (v) new markets tax credit under section 45D, (vi) empowerment zone employment credit under section 1396(a), (vii) renewal community employment credit under section 1400H, or (viii) employee retention credit under section 1400R.

⁴³ Prop. Treas. Reg. § 1.6011-4(b)(6), 71 Fed. Reg. 64488, 64491 (Nov. 2, 2006); Treas. Reg. § 1.6011-4.

⁴⁴ Reg. § 1.6011-4(b)(6).

⁴⁵ Prop. Treas. Reg. § 1.6011-4, preamble, 71 Fed. Reg. 64488 (Nov. 2, 2006); T.D. 9350, 72 Fed. Reg. 43146.

⁴⁶ Treas. Reg. § 1.6011-4(b)(6).

of persons identified in the transaction in that published guidance.⁴⁷

- According to the proposed regulations' preamble, if the IRS and Treasury Department determine that a transaction of interest is a tax avoidance type of transaction, they may take actions, including re-classifying the transaction of interest as a listed transaction, or creating a new category of reportable transactions. Conversely, if it is determined that the transaction of interest is not a tax avoidance type of transaction, the transaction may be removed from the transaction of interest category in published guidance.⁴⁸
- Further, listed transactions do not have to be transactions of interest before the transactions are identified as listed transactions.⁴⁹
- The transactions of interest category of reportable transactions apply to transactions entered into on or after November 2, 2006.⁵⁰
- The IRS has identified four transactions of interest thus far.
 - The "Contribution of Successor Member Interest" transaction of interest involves a section 170 charitable contribution deduction for a section 170(c) transfer of certain real property interests that is significantly higher

⁴⁷ Treas. Reg. § 1.6011-4(c)(3)(E).

⁴⁸ Prop. Treas. Reg. § 1.6011-4, preamble, 71 Fed. Reg. 64488 (Nov. 2, 2006). In addition, the final regulations do not adopt commentators' recommendation that, unless the IRS and Treasury Department affirmatively act to extend the period during which a transaction may be considered a transaction of interest, such period be limited to 24 months. T.D. 9350, 72 Fed. Reg. 43146.

⁴⁹ Prop. Treas. Reg. § 1.6011-4, preamble, 71 Fed. Reg. 64488 (Nov. 2, 2006).

⁵⁰ Treas. Reg. § 1.6011-4(h)(1).

than the amount the taxpayer paid for the transferred rights.⁵¹

- The “Toggling Grantor Trust” transaction of interest involves a purported termination and subsequent re-creation of the trust’s grantor trust status to allow the grantor to either (i) claim a tax loss in excess of the actual economic loss sustained by the taxpayer, or (ii) inappropriately avoid the recognition of gain.⁵²
- The “Potential for Avoidance of Tax Through Sale of Charitable Remainder Trust Interests” transaction of interest involves the contribution of appreciated assets to a charitable remainder trust and their reinvestment by the trust, followed by the disposition of all interests in the charitable remainder trust, which results in the grantor or other noncharitable recipient receiving value from the trust while claiming to recognize little or no taxable gain.⁵³
- The “Subpart F Income Partnership Blocker” transaction of interest involves a U.S. taxpayer that owns a CFC that holds stock of a lower-tier CFC through a domestic partnership and takes the position that neither subpart F income of the lower-tier CFC nor any section 956(a) amount related to holdings of U.S. property by the lower-tier CFC results in income inclusions under section 951(a) for the U.S. taxpayer.⁵⁴

G. Leasing Transactions

- Under prior regulations, certain commercial leases of tangible personal property described in Notice

⁵¹ Notice 2007-72, 2007-36 I.R.B. 544.

⁵² Notice 2007-73, 2007-36 I.R.B. 545.

⁵³ Notice 2008-99, 2008-47 I.R.B. 1194.

⁵⁴ Notice 2009-7, 2009-3 I.R.B. 312.

2001-18⁵⁵ were excluded from all reportable transaction categories except the listed transaction category. The regulations issued in August, 2007 eliminate this special rule for leasing transactions and subject leasing transactions to the same disclosure rules as other transactions.⁵⁶

H. Patented Transactions

- Regulations proposed in September, 2007 would add patented transactions to the list of reportable transactions. If issued in final form, the proposed regulations would apply to transactions entered into after September 25, 2007.⁵⁷
- The proposed regulations define a patented transaction as (i) any transaction for which a taxpayer pays any fee to a patent holder for the legal right to use a tax planning method, and (ii) any transaction for which a patent holder or its agent has the right to payment for another person's use of a tax planning method that is the subject of the patent.⁵⁸

⁵⁵ Notice 2001-18, 2001-1 C.B. 731.

⁵⁶ Treas. Reg. § 1.6011-4. *See also* Prop. Treas. Reg. § 1.6011-4, preamble, 71 Fed. Reg. 64488, 64489 (Nov. 2, 2006). The government believes that modifications of the reportable transaction categories will except most customary commercial leasing transactions from the reportable transaction rules and thus they would not be subject to disclosure. Further, the IRS and Treasury Department intend to obsolete Notice 2001-18, 2001-1 C.B. 731.

⁵⁷ Prop. Treas. Reg. § 1.6011-4(h)(2).

⁵⁸ Prop. Treas. Reg. § 1.6011-4(b)(7).

A "Patent" means a patent, either applied for or granted, under the provisions of title 35 of the United States Code, and a "patent holder" is defined by reference to Treasury regulation section 1.1235-2. Prop. Treas. Reg. § 1.6011-4(b)(7)(ii)(C). The "patent holder's agent" is any person who (i) has patent holder's permission to offer for sale, market, or sell a tax planning method subject to a patent, or (ii) receives (directly or indirectly) on patent holder's behalf a fee in any amount for a tax planning method subject to a patent. Prop. Treas. Reg. § 1.6011-4(b)(7)(ii)(D). "Tax planning

- The taxpayer must know or have reason to know that the tax planning method is the subject of a patent.⁵⁹
- Under the proposed regulations, a taxpayer would be considered to participate in a patented transaction if:⁶⁰
 - The taxpayer’s tax return reflects a benefit from the patented transaction, or
 - The taxpayer is the patent holder (or agent) whose tax return reflects either (i) a tax benefit in relation to obtaining a patent for a tax planning method (*e.g.*, any deduction for payments to the United States Patent and Trademark Office), or (ii) income from a payment received from another person for the use of the patented tax planning method.

I. Former Reportable Transactions

- A transaction giving rise to a significant book-tax difference was defined as any transaction involving an SEC reporting company or a company with \$250 million or more in gross assets that gives rise to a book-tax difference under U.S. GAAP of more than

method” is any plan, strategy, technique, or structure designed to affect Federal income, estate, gift, generation skipping transfer, employment, or excise taxes. Prop. Treas. Reg. § 1.6011-4(b)(7)(ii)(F). The term does not include a patent issued solely for tax preparation software or other tools used to perform or model mathematical calculations or to provide mechanical assistance in the preparation of tax or information returns.

A “fee” includes any consideration that the taxpayer knows or has reason to know will be paid indirectly to the patent holder or patent holder’s agent (*e.g.*, a referral fee, fee sharing agreement, or license), but does not include settlement or damages payments in a suit for damages for infringement of the patent. Prop. Treas. Reg. § 1.6011-4(b)(7)(ii)(A).

⁵⁹ Prop. Treas. Reg. § 1.6011-4(b)(7).

⁶⁰ Prop. Treas. Reg. § 1.6011-4(c)(3)(i)(F).

\$10 million in any year, other than certain exempted transactions.⁶¹

- In January 2006, the IRS issued Notice 2006-6 which eliminates the book-tax difference category of reportable transactions. The removal of this category of reportable transactions applies to transactions that would otherwise have to be disclosed by taxpayers or disclosed or listed by material advisors on or after January 6, 2006.⁶² The IRS issued proposed regulations in 2006, and final regulations in August 2007, consistent with the Notice.^{63 64}
- A tax credit transaction involving a brief holding period was defined as any transaction in which the taxpayer claims tax credits exceeding \$250,000 and holds the underlying asset for 45 days or less (disregarding days for which the taxpayer is hedged).⁶⁵
 - Query: Would a transaction involving an asset held since inception, albeit for less than 45 days, constitute a reportable transaction under this provision?
 - A taxpayer participated in a brief asset holding period transaction if the taxpayer's tax return

⁶¹ Treas. Reg. § 1.6011-4(b)(6)(i), (ii)(A) (prior to August, 2007).

⁶² Notice 2006-6, 2006-1 C.B. 385.

⁶³ Prop. Treas. Reg. § 1.6011-4, 71 Fed. Reg. 64488 (Nov. 2, 2006). The IRS and Treasury Department determined that characterization as a reportable transaction is no longer necessary since Schedule M-3 includes disclosure of book-tax differences for corporations.

⁶⁴ Treas. Reg. § 1.6011-4.

⁶⁵ Treas. Reg. § 1.6011-4(b)(7) (prior to August, 2007). The principles of section 246(c)(3) and (c)(4) apply for purposes of determining an asset's holding period. Rev. Proc. 2004-68, 2004-2 C.B. 969.

reflects a tax credit exceeding \$250,000 from a brief asset holding period transaction.⁶⁶

- Revenue Procedure 2004-68 exempted the following transactions from brief asset holding period reportable transaction characterization: (i) in the case of transactions involving solely foreign tax credits, sales of inventory made in the ordinary course of the taxpayer's trade or business,⁶⁷ (ii) transactions involving a brief asset holding period under the principles of section 246(c)(4) solely by reason of (A) a hedge that reduces only the risk of interest rate or currency fluctuations, or (B) a guarantee issued by a related person, (iii) transactions involving a debt instrument that has a term of 45 days or less if the taxpayer's holding period in the debt instrument equals the debt instrument's entire term,⁶⁸ and (iv) transactions that are not disallowed under section 901(l) resulting in a foreign tax credit for withholding taxes imposed in respect of non-dividend income or gain with respect to any property (including transactions eligible for the securities dealer exception under section 901(l)(2)).⁶⁹
- Regulations issued in August, 2007 removed the brief asset holding period transactions from a list of reportable transactions.⁷⁰

⁶⁶ Treas. Reg. § 1.6011-4(c)(3)(i)(F) (prior to August, 2007).

⁶⁷ This exception applied only to credits with respect to sales proceeds and not to the receipt of other income, such as interest received on bonds held in inventory.

⁶⁸ For purposes of this exception, the taxpayer's holding period in the debt instrument was determined under Treasury regulation section 1.6011-4(b)(7), except that the taxpayer's holding period is not reduced as a result of a hedge that reduces only the risk of interest rate or currency fluctuations or a guarantee issued by a related person.

⁶⁹ Rev. Proc. 2004-68, 2004-2 C.B. 969.

⁷⁰ Treas. Reg. § 1.6011-4. The IRS and Treasury Department have determined that changes in section 901 rendered the brief asset

J. Effect of Rules on Shareholders of Foreign Corporations

- If a “controlled foreign corporation” enters into a transaction that would be a reportable transaction if the CFC were a domestic corporation, any United States person that owns 10% of the voting stock in the CFC is treated as participating in a reportable transaction.⁷¹
- If a “passive foreign investment company” enters into a transaction that would be a reportable transaction if the PFIC were a domestic corporation, any United States person that owns 10% of the stock (by vote or value) of a PFIC with respect to which it has made a “qualified electing fund” election is treated as participating in a reportable transaction.⁷²

K. Effect of Rules on Tax-Exempt Entities

- A tax-exempt entity that becomes a party to a “prohibited tax shelter transaction” may be subject to an excise tax.⁷³
 - A “prohibited tax shelter transaction” is any listed transaction and any confidential transaction or any reportable transaction with contractual protection.⁷⁴

holding period reportable transaction category unnecessary. *See* T.D. 9350, 72 Fed. Reg. 43146.

⁷¹ Treas. Reg. § 1.6011-4(c)(3)(i)(G). A CFC is any foreign corporation in which U.S. persons holding 10% of the voting stock together own more than 50% of the vote or value of its stock. *See* I.R.C. § 957.

⁷² Treas. Reg. § 1.6011-4(c)(3)(i)(G). A PFIC is a foreign corporation 75% or more of the income of which is passive or 50% or more of the assets of which generate passive income. *See* I.R.C. § 1297.

⁷³ I.R.C. § 4965(a).

⁷⁴ I.R.C. § 4965(e)(1).

- Many tax practitioners expressed concern and requested guidance regarding when a tax-exempt entity would be considered a “party” to a transaction. In response, the IRS issued Notice 2007-18.⁷⁵
 - Under the notice, a tax-exempt entity is a party to a transaction if it (i) facilitates the transaction by reason of its tax-exempt, tax indifferent, or tax-favored status, or (ii) is identified in published guidance, by type, class or role, as a party to a prohibited transaction.⁷⁶
 - The IRS may also identify in future guidance tax-exempt entities that will not be treated as a party to a prohibited transaction.⁷⁷
- The amount of the excise tax imposed on the tax-exempt entity is equal to 35% of the greater of (i) 100% of the entity’s net income attributable to the transaction, and (ii) 75% of the entity’s proceeds attributable to the transaction,⁷⁸ unless the tax-exempt entity knew or had reason to know that the transaction was a prohibited transaction at the time it entered the transaction, in which case the excise tax is the greater of (i) 100% of the entity’s net income attributable to the prohibited transaction, or

⁷⁵ Notice 2007-18, 2007-9 I.R.B. 608.

⁷⁶ Notice 2007-18, 2007-9 I.R.B. 608. According to the notice, the IRS and Treasury Department recognize that “party” as used in section 4965 applies more broadly than the term is defined for purposes of the notice. Accordingly, the IRS and Treasury Department will propose regulations that define “party” under section 4965 to include a tax-exempt entity that enters into a prohibited tax shelter transaction that reduces the entity’s U.S. tax liability (*i.e.*, employment taxes, excise taxes, and in appropriate cases unrelated business income tax). The IRS anticipates issuing further guidance under section 4965 and has invited comments, particularly regarding the definition of the term “party to a prohibited tax shelter transaction.”

⁷⁷ Notice 2007-18, 2007-9 I.R.B. 608.

⁷⁸ I.R.C. § 4965(b)(1)(A).

(ii) 75% of the proceeds attributable to the transaction.⁷⁹

- A tax-exempt entity that became a party to a transaction before the IRS identified the transaction as a listed transaction will also be subject to an excise tax in an amount equal to 35% of the greater of (i) 100% of the entity's net income attributable to the transaction, and (ii) 75% of the entity's proceeds attributable to the transaction.⁸⁰
- An excise tax will also be imposed on any manager of a tax-exempt entity who knew or who had reason to know that a transaction was a prohibited tax shelter transaction and approved or caused the entity to become a party to the transaction.⁸¹
 - The amount of the manager excise tax is \$20,000 for each approval or act causing the entity to participate in a prohibited transaction.⁸²
- A tax-exempt entity that is a party to a prohibited tax shelter transaction must disclose (i) its participation in the prohibited transaction, and (ii) the identity of any other parties known by the tax-exempt entity to be a party to the transaction.⁸³
 - A taxable entity or person that participates with a tax-exempt entity in a prohibited tax shelter transaction must provide a written statement to the tax-exempt entity disclosing that the transaction is a prohibited transaction.⁸⁴
- Proposed regulations, which would generally apply to taxable years ending after July 6, 2007, if issued

⁷⁹ I.R.C. § 4965(b)(1)(B).

⁸⁰ I.R.C. § 4965(b)(1)(B).

⁸¹ I.R.C. § 4965(a)(2).

⁸² I.R.C. § 4965(b)(2).

⁸³ I.R.C. § 6033(a)(2).

⁸⁴ I.R.C. § 6011(g).

in final form,⁸⁵ would treat a tax-exempt entity⁸⁶ as a party to a prohibited tax shelter transaction⁸⁷ if the entity (i) facilitates a prohibited tax shelter transaction by reason of its tax-exempt, tax indifferent or tax favored status, (ii) is identified in published guidance (by type, class, or role) as a party to a prohibited tax shelter transaction, or (iii) enters into a listed transaction that reduces or eliminates the entity's Federal employment, excise or unrelated business income taxes.⁸⁸

- A tax-exempt entity defined in section 4965(c)(1), (2), or (3), or a manager of a tax-exempt entity defined in section 4965(c)(4), (5), (6), or (7) would have to disclose the entity's participation in a prohibited tax shelter transaction on Form 8886-T.⁸⁹

⁸⁵ Prop. Treas. Reg. § 53.4965-9(b). The proposed regulations would apply to (i) a tax-exempt entity that knowingly entered into a prohibited tax shelter transaction after May 17, 2006, and (ii) a manager who caused a tax-exempt entity to enter into a prohibited tax shelter transaction after May 16, 2006. Prop. Treas. Reg. § 53.4965-9(c).

⁸⁶ The proposed regulations generally cross-reference section 4965(c) for the definition of the covered "tax-exempt entities." Prop. Treas. Reg. § 53.4965-2(a). In addition, the proposed regulations would divide the tax-exempt entities referred to in section 4965(c) into plan entities and non-plan entities.

Non-plan tax-exempt entities would include entities described in sections 501(c), 501(d) and 170(c) (other than the United States), and Indian tribal governments described in section 7701(a)(40).

⁸⁷ The proposed regulations would apply to listed transactions within the meaning of section 6707A(c)(2) (including those identified as listed transactions after the tax-exempt entity has entered into the transaction), confidential transactions described in Treasury regulation section 1.6011-4(b)(3), and transactions with contractual protection, as described in Treasury regulation section 1.6011-4(b)(4). Prop. Treas. Reg. § 53.4965-3.

⁸⁸ Prop. Treas. Reg. § 53.4965-4.

⁸⁹ The tax-exempt entity would also have to disclose the identity of any other party to the transaction that is known to the tax-exempt entity. Temp. Treas. Reg. § 1.6033-5T(a), (d). In general, Form 8886-T

- In addition, Form 4720 must be filed by a tax-exempt entity described in section 4965(c)(1), (2), or (3) that is a party to a prohibited tax-shelter transaction and liable for tax under section 4965(a) on or before the due date (not including extensions) for the entity's annual information return under section 6033(a)(1).⁹⁰
- The proposed regulations would impose the same amount of tax on a non-plan tax-exempt entity as section 4965(b)(1), including additional tax when the entity knew or had reason to know that it was entering into a prohibited tax shelter transaction.⁹¹

would have to be filed before May 16 of the calendar year following the close of the calendar year during which (i) the tax-exempt entity entered into the prohibited tax shelter transaction, or (ii) the transaction is identified as a listed transaction, if it is so identified after the tax-exempt entity enters the transaction. Temp. Treas. Reg. § 1.6033-5T(e). Penalties under section 6652(c)(3) apply for failure to properly file Form 8886-T with respect to transactions entered into after May 17, 2006. Temp. Treas. Reg. § 1.6033-5T(f), (g). The sunset date for this provision is July 6, 2010. Temp. Treas. Reg. § 1.6033-5T(g)(2).

⁹⁰ Temp. Treas. Reg. § 53.6071-1T(g). Managers of tax-exempt entities who are subject to section 4965(a) tax, and tax-exempt entities subject to section 4965(a) tax that do not file annual information returns, must file Form 4720 before the 16th day of the fifth month following the close of the manager's or the entity's taxable year (respectively) during which the entity entered into the transaction. This rule applies between July 6, 2007 and July 6, 2010. Temp. Treas. Reg. § 53.6071-1T(h).

With respect to tax-exempt entities described in section 4965(c)(4), (5), (6), or (7), Form 5330 must be filed by the entity manager before the 16th day of the fifth month following the close of the manager's taxable year during which the entity entered into the prohibited tax shelter transaction. This rule applies between July 6, 2007 and July 5, 2010. Temp. Treas. Reg. § 54.6011-1T(c), (d).

⁹¹ Prop. Treas. Reg. § 53.4965-7(a). In general, the income subject to tax would be (i) in the case of a tax-exempt entity that facilitates the transaction for others, the gross amount of consideration for facilitating the transaction, not reduced for any costs attributable to the transaction, and (ii) in the case of a tax-exempt entity that attempts to reduce or eliminate its own Federal taxes, the tax savings

- The proposed regulations would treat a tax-exempt entity as knowing or having reason to know that it was entering into a prohibited tax shelter transaction if at least one of its managers knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time they caused the entity's becoming a party to the transaction.⁹²
- In general, the proposed regulations would adopt a facts and circumstances test to determine whether an entity's manager knows or has reason to know that the transaction is a prohibited tax shelter transaction.⁹³
 - Failure on the part of the manager to seek professional tax advice would

purportedly generated by the transaction and claimed by the entity on its tax return for the tax year. Prop. Treas. Reg. § 53.4965-8.

The proposed regulations would generally allocate net income and proceeds attributable to a prohibited tax shelter transaction consistently with the tax-exempt entity's established method of accounting. Prop. Treas. Reg. § 53.4965-8.

⁹² Prop. Treas. Reg. § 53.4965-6(a). Non-plan tax-exempt entities would be treated as knowing or having reason to know that it was entering into a tax shelter transaction if a person with the authority or responsibility of an officer, director, or trustee knows or has reason to know, whether or not the person causes the entity to be a party to the transaction.

⁹³ Prop. Treas. Reg. § 53.4965-6(b). To meet this standard, the manager must know sufficient facts that would lead a reasonable person in the manager's circumstances to conclude that the transaction was a prohibited tax shelter transaction.

Among other factors, the proposed regulations would consider (i) the presence of tax shelter indicia (*e.g.*, the transaction is of significant size relative to the receipts of the entity), (ii) whether prior to the consummation of the transaction the manager received a section 6011(g) disclosure statement indicating that the transaction might be a tax shelter transaction, and (iii) whether the manager made appropriate inquiries into the transaction (*e.g.*, after receiving a disclosure statement).

not by itself give rise to an inference that the manager had reason to know that a transaction is a prohibited tax shelter transaction.⁹⁴

- In general, if the entity enters into a transaction before it is identified as a listed transaction, the manager would not be treated as knowing or having reason to know that a transaction is a prohibited tax shelter transaction.⁹⁵
- In addition, the proposed regulations would subject a manager to a \$20,000 tax if the manager (i) causes the tax-exempt entity to become a party to a prohibited tax shelter transaction, and (ii) knew or had reason to know that the transaction is a prohibited tax shelter transaction.⁹⁶

⁹⁴ Prop. Treas. Reg. § 53.4965-6(c)(1). In addition, reasonable good faith reliance on the written opinion of a professional tax advisor would establish that the manager did not have a reason to know that a transaction was a prohibited tax shelter transaction. Whether reliance is reasonable and in good faith would be determined by taking into account all facts and circumstances, including the manager's education, sophistication, and business experience. Prop. Treas. Reg. § 53.4965-6(c)(2).

Reliance on professional advice would not be reasonable and in good faith if the manager knew or should have known that the tax advisor lacked knowledge in the relevant aspects of Federal tax law, or if the manager fails to disclose a fact that the manager reasonably knew or should have known would be relevant to determining whether the transaction is a prohibited tax shelter transaction.

⁹⁵ Prop. Treas. Reg. § 53.4965-6(d).

⁹⁶ Prop. Treas. Reg. § 53.4965-7(b). The provision would potentially apply to all managers falling under its definition, and would subject each to a separate manager-level tax. A person would be treated as causing a tax-exempt entity to enter into a prohibited tax shelter transaction if the person (i) has the authority to commit the entity to the transaction, and (ii) exercises that authority. A member of a collective body that commits the entity to a prohibited tax shelter transaction would be treated as exercising the authority to commit the entity to the transaction only if such member votes in favor of committing the entity to the transaction.

- Proposed regulations would also require a taxable party⁹⁷ to a prohibited tax shelter transaction to disclose⁹⁸ to each tax-exempt entity that enters the transaction⁹⁹ after May 17, 2006 that the transaction is a prohibited tax shelter transaction.¹⁰⁰
- The disclosure statement would have to identify the type of prohibited tax shelter transaction and state that the tax-exempt entity and/or its manager may be subject to a section 4965 tax.¹⁰¹

⁹⁷ Under the proposed regulations, a “taxable party” would be a person who is identified as a taxable party by the Secretary in published guidance, or who has entered into a transaction under Treasury regulation sections 1.6011-4(c)(3)(i), 20.6011-4, 25.6011-4, 31.6011-4, 53.6011-4, 54.6011-4, or 56.6011-4.

A person would become a taxable party to a prohibited tax shelter transaction which becomes a listed transaction after the person files a tax return (including an amended return) reflecting tax consequences of the transaction on the date the listed transaction is identified in published guidance. Prop. Treas. Reg. § 301.6011(g)-1(c).

⁹⁸ Multiple taxable parties required to disclose a prohibited tax shelter transaction would be able to designate a single taxable party to make the disclosure statement; however, they would not be relieved of their filing obligation if the designated party fails to file the disclosure statement. Prop. Treas. Reg. § 301.6011(g)-1(h).

⁹⁹ A tax-exempt entity would be a party to a prohibited tax shelter transaction if the entity facilitates a prohibited tax shelter transaction by reason of its tax-exempt, tax indifferent or tax-favored status, or is identified in published guidance (by type, class or role). Prop. Treas. Reg. § 301.6011(g)-1(b).

¹⁰⁰ Prop. Treas. Reg. § 301.6011(g)-1(a), (j).

A disclosure form would have to be filed for every tax-exempt entity that is a party to the transaction. Prop. Treas. Reg. § 301.6011(g)-1(e).

¹⁰¹ Prop. Treas. Reg. § 301.6011(g)-1(f).

The disclosure would have to be made to any manager (or the primary contact on the transaction if the manager is unknown) in the case of a non-plan tax-exempt entity, and to a manager who caused the tax-exempt entity to enter the transaction in the case of a plan tax-exempt entity. Prop. Treas. Reg. § 301.6011(g)-1(g).

- The disclosure requirement would apply only if the taxable party knows or has reason to know (a facts and circumstances inquiry) that a tax-exempt entity is a party to a prohibited tax shelter transaction.¹⁰² Penalties under section 6707A would apply to any taxable entity that fails to file a required disclosure statement.¹⁰³
- A taxable party would have to file the disclosure by the later of 60 days after (i) the person becomes a taxable party, or (ii) the taxable party knows or has reason to know that a tax-exempt entity is a party to the transaction.¹⁰⁴

III. TAX SHELTER LISTING REQUIREMENTS FOR MATERIAL ADVISORS

A. General Requirements

- Each “material advisor” is subject to listing requirements. Material advisors include any person or entity that:
 - Knows or reasonably expects that a transaction will become a reportable transaction, makes any oral or written statement regarding a tax aspect of a transaction that causes it to be a reportable transaction, and earns for the material aid, assistance or advice, directly or indirectly, in excess of \$50,000 in the case of a reportable transaction,

¹⁰² This determination may be based on the extent of the efforts made to determine whether a tax-exempt entity is facilitating the transaction and the extent of the efforts made to determine the identity of the tax-exempt entity. Prop. Treas. Reg. § 301.6011(g)-1.

¹⁰³ Prop. Treas. Reg. § 301.6011(g)-1(i).

¹⁰⁴ Prop. Treas. Reg. § 301.6011(g)-1(d). A taxable party is not required to make the disclosure if it does not know and does not have a reason to know that a tax-exempt entity is a party to the transaction on or before the first date on which the transaction is required to be disclosed by the person under Treasury regulation sections 1.6011-4, 20.6011-4, 25.6011-4, 31.6011-4, 53.6011-4, 54.6011-4, or 56.6011-4.

substantially all of the tax benefits of which are provided to individuals looking through any partnerships, S-corporations, or trusts (\$10,000 for a listed transaction), and in excess of \$250,000 in all other cases (\$25,000 for a listed transaction).¹⁰⁵

- The “substantially all” requirement is generally met if at least 70 percent of the tax benefits are provided to natural persons (looking through any partnerships, S corporations, or trusts), unless the facts and circumstances indicate otherwise.¹⁰⁶
- A person or entity is considered to be a material advisor with respect to a reportable transaction if the person or entity makes a tax statement to another material advisor to a reportable transaction and derives income in excess of the threshold amount.¹⁰⁷ In such a case, the person or entity may be required to maintain list information regarding taxpayers who are not clients of that person or entity.
- A statement that includes only information contained in publicly available documents filed with the SEC by the close of a

¹⁰⁵ The term “material advisor” is defined under Treasury Regulation § 301.6111-3(b) for purposes of Treasury Regulation § 301.6112-1. Treas. Reg. § 301.6112-1(c)(1).

Prior proposed regulations would have lowered the threshold amounts for patented transactions to \$250 for transactions substantially all of the tax benefits of which are provided to individuals, and to \$500 for all other transactions. Prop. Treas. Reg. § 301.6111-3(b)(3)(i)(C). The final regulations did not adopt this change.

The IRS and Treasury may reduce the income threshold in published guidance for transactions of interest. Treas. Reg. § 301.6111-3(b)(3)(i)(B).

¹⁰⁶ Treas. Reg. § 301.6111-3(b)(3)(i)(D).

¹⁰⁷ Treas. Reg. § 301.6111-3(b)(2)(i).

transaction will not be considered a tax statement for this purpose.¹⁰⁸

- A person is not considered a material advisor with respect to a transaction if the tax advisor provides a tax statement regarding the transaction only after the first tax return reflecting the tax benefit of the transaction is filed with the IRS. This exception does not apply if it is expected that the taxpayer will file a supplemental or amended return reflecting additional tax benefits from the transaction.¹⁰⁹
- With respect to a pre-January 6, 2006 significant book-tax difference transaction, a person will be considered a material advisor only if the person both makes the tax statement and also makes a statement relating to the financial accounting treatment of the item giving rise to the book-tax difference.¹¹⁰

B. List Maintenance Requirements

- Material advisors must maintain a list for 7 years for possible inspection by the IRS of those persons to whom the advisor made tax statements, together with certain other information, as described below.¹¹¹
- Multiple material advisors that are required to maintain lists may designate a single material advisor to maintain the list.¹¹² However, the designation of one material advisor to maintain a list does not relieve the other material advisors from

¹⁰⁸ Treas. Reg. § 301.6111-3(b)(iii)(C).

¹⁰⁹ Treas. Reg. § 301.6111-3(b)(2)(iii)(B).

¹¹⁰ Notice 2004-80, 2004-50 I.R.B. 963; *see also* Notice 2006-6, 2006-1 C.B. 385 (eliminated book-tax difference transactions from categories of reportable transactions).

¹¹¹ Treas. Reg. § 301.6112-1(d).

¹¹² Treas. Reg. § 301.6112-1(f).

their obligation to furnish the list to the IRS if the designated list keeper fails to do so.¹¹³

- In light of the potential for continuing liability, non-designated material advisors should consider obtaining a copy of the listing materials described below, perhaps on electronic media.
- The following items must be included on material advisors' lists:¹¹⁴
 - Itemized statement containing the following information:
 - Identifying information about the taxpayer (*e.g.*, name, address, TIN) and identifying information about the transaction (*e.g.*, name, registration number).
 - The date on which each taxpayer entered into each reportable transaction (if known).
 - Amount of money invested in the transaction by each taxpayer (if known).
 - Summary or schedule of intended or expected tax treatment to be derived from the transaction by each taxpayer.
 - Names of other material advisors to the transaction (if known).
 - Detailed description of each transaction, including the tax structure and its expected tax treatment.
 - Documents, including a copy of the designation agreement to which the material advisor is a party (if any), and copies of any additional written materials, including tax analyses or opinions, that are material to an understanding of the purported

¹¹³ Treas. Reg. § 301.6112-1(f).

¹¹⁴ Treas. Reg. § 301.6112-1(b)(3)(1).

tax treatment or tax structure of the transaction that have been shown or provided to any actual or potential investor in the transaction.¹¹⁵

- Potential material advisors are obligated to maintain a list with respect to transactions for which a private letter ruling is sought as to whether a transaction is a reportable transaction is requested on or after November 1, 2006.¹¹⁶
- Each material advisor responsible for maintaining list information must, upon written request, furnish the list to the IRS within the period prescribed within section 6708 (or published guidance thereunder) from the day on which the request was provided.¹¹⁷
- A material advisor who has a reasonable belief that information required to be furnished to the IRS is privileged remains obligated to maintain list information.¹¹⁸

IV. TAX SHELTER DISCLOSURE REQUIREMENTS FOR MATERIAL ADVISORS

- The JOBS Act replaced the tax shelter registration regime that existed under prior law with a requirement that “material advisors” file information returns with the IRS for reportable transactions.¹¹⁹

¹¹⁵ A material advisor is not required to retain earlier drafts of a document, provided the later (or final) draft contains all the information in the earlier drafts that is material to the understanding of the purported tax treatment or the tax structure of the transaction.

¹¹⁶ Treas. Reg. § 301.6111-3(h), (i).

¹¹⁷ Treas. Reg. § 301.6112-1(e)(1). Section 6708 currently provides that the list must be made available within 20 business days after the day on which the request was provided. According to the preamble to the regulations, an alternative schedule for furnishing the list will be addressed in published guidance under section 6708. *See* T.D. 9352, 72 Fed. Reg. 43154.

¹¹⁸ Treas. Reg. § 301.6112-1(e)(2).

¹¹⁹ Act Sec. 815 of the JOBS Act, amending I.R.C. § 6111.

- In response to the Jobs Act provisions, the IRS and Treasury Department issued Notice 2004-80, providing interim guidance on the material advisor disclosure requirements.¹²⁰ After receiving questions and comments on the application of the material advisor rules, in November 2006, the IRS and Treasury Department proposed regulations relating to the material advisor disclosure requirements¹²¹ that were issued in final regulations in August, 2007.¹²²
- A “material advisor” for purposes of this requirement has the same definition as for purposes of the material advisor listing requirements.¹²³
- A person becomes a material advisor when all of the following events have occurred:
 - the material advisor makes a tax statement,¹²⁴
 - the material advisor directly or indirectly receives the minimum fees, and
 - the transaction is entered into by the taxpayer.¹²⁵

¹²⁰ Notice 2004-80, 2004-50 I.R.B. 963.

¹²¹ Prop. Treas. Reg. § 301.6111-3, 71 Fed. Reg. 64496 (Nov. 2, 2006).

¹²² Treas. Reg. § 301.6111-3.

¹²³ New section 6111(c) permits the IRS to prescribe regulations that (i) require only one material advisor to file an information return in situations where two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (ii) exempt certain persons or transactions from the reporting requirements, and (iii) provide other rules for carrying out the purposes of the reporting requirements, including rules for aggregating fees in appropriate circumstances.

Parties to the designation agreement may still be liable for penalties under section 6707 if the designated material advisor fails to disclose the reportable transaction. Treas. Reg. § 301.6111-3(f).

¹²⁴ The definition of a tax statement includes another person’s statement that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction. Treas. Reg. § 301.6111-3(b)(2)(ii)(A).

- If a transaction that was not a reportable transaction when entered into by the taxpayer is later identified as a listed transaction or a transaction of interest, a person who otherwise would have constituted a material advisor when the transaction was entered into will subsequently be considered to have become a material advisor with respect to the transaction on the date the transaction is identified as a listed transaction or transaction of interest.¹²⁶ Thus, to ensure compliance with the disclosure and list maintenance requirements practitioners will need to monitor the status of closed transactions and determine whether closed transactions are later identified as listed transactions or transactions of interest.
- A “reportable transaction” for purposes of this requirement has the same definition as for purposes of the participant disclosure requirements.¹²⁷
- Each material advisor must timely file an information return with the IRS with respect to any reportable transaction for which the material advisor

¹²⁵ Treas. Reg. § 301.6111-3(b)(4). Material advisors, including those who cease providing services prior to the time the transaction is entered into), must make reasonable and good faith efforts to determine whether the taxpayer enters into the transaction. Treas. Reg. § 301.6111-3(b)(4)(ii).

A person is also considered to be a material advisor and has disclosure obligations if the person makes a tax statement with respect to a transaction and it is expected that the taxpayer will file a supplemental or amended return reflecting additional tax benefits from the transaction. Treas. Reg. § 301.6111-3(b)(2)(iii)(B).

¹²⁶ Treas. Reg. § 301.6111-3(b)(4)(iii).

¹²⁷ Treas. Reg. § 301.6111-3(c)(1). For purposes of new section 6111(a) a “reportable transaction” is defined in Treasury regulations section 1.6011-4(b) as (i) listed transactions, (ii) confidential transactions, (iii) loss transactions, (iv) contractual protection transactions, and (v) transactions of interest.

provided material aid, assistance or advice on or after August 3, 2007.¹²⁸ The return must include:

- information identifying and describing the transaction,
- information describing any potential tax benefits expected to result from the transaction, and
- such other information as the IRS may prescribe.¹²⁹
 - Material advisor must describe any tax result protection with respect to the transaction.¹³⁰
 - The provision of tax result protection for a reportable transaction may subject a person to the section 6111 material advisor disclosure rules, because tax statements include third party tax result

¹²⁸ Treasury Regulation section 301.6111-3 applies to transactions with respect to which a material advisor makes a tax statement on or after August 3, 2007 (November 2, 2006 for transactions of interest entered into on or after November 2, 2006). The rules that apply with respect to transactions entered into before August 3, 2007 are contained in Notice 2004-80, 2004-50 I.R.B. 963; Notice 2005-17, 2005-1 C.B. 606; and Notice 2005-22, 2005-1 C.B. 756. Treas. Reg. § 301.6111-3(i).

A person provides material aid with respect to a reportable transaction by making or providing a statement to or for the benefit of (i) a taxpayer who is required to disclose the transaction, (ii) a taxpayer who the potential material advisor knows is, or reasonably expects to be, required to report the transaction, (iii) a material advisor who is required to disclose the transaction, or (iv) a material advisor who the potential material advisor knows is, or reasonably expects to be, required to report the transaction. Treas. Reg. § 301.6111-3(b)(2).

¹²⁹ I.R.C. § 6111(c), as amended by the JOBS Act. The IRS may seek from the material advisor the same type of information that the IRS may request from a taxpayer with respect to a reportable transaction. Treas. Reg. § 301.6111-3(d).

¹³⁰ Treas. Reg. § 301.6111-3(d).

protection that insures the tax benefits of a reportable transaction.¹³¹

- A material advisor's disclosure statement must describe the transaction in enough detail for the IRS to be able to understand the tax structure of the transaction and the identity of the material advisors who the material advisor knows or has reason to know acted as material advisors with respect to the transaction.¹³²
- A potential material advisor may make a protective disclosure if the advisor is uncertain as to whether the transaction is a reportable transaction.¹³³
- Potential material advisors may request a ruling on whether a transaction is a reportable transaction, however the deadline for providing disclosure will not be tolled during the pendency of the ruling request.¹³⁴
- The information return must be filed on IRS Form 8918 by the last day of the first month after the end of the calendar quarter during which the advisor becomes a material advisor.¹³⁵
- Once a material advisor has filed an IRS Form 8918 with respect to a particular transaction, there is no requirement to file an additional Form 8918 for

¹³¹ Treas. Reg. § 301.6111-3(b)(2)(ii). However, a transaction will not constitute a reportable transaction solely because it has tax result protection.

¹³² Treas. Reg. § 301.6111-3(d)(1).

¹³³ The protective disclosure must include all information required under Treasury Regulation section 301.6111-3 and Treasury Regulation section 301.6112-1 in order to be effective. Treas. Reg. § 301.6111-3(g).

¹³⁴ Treas. Reg. § 301.6111-3(h).

¹³⁵ Treas. Reg. § 301.6111-3(d), (e).

A material advisor required to file a completed Form 8918 by October 31, 2007 may file Form 8264 instead (due to unavailability of Form 8918). *See* Notice 2007-85, 2007-45 I.R.B. 965.

subsequent taxpayers that enter into the transaction or further transactions that are the same or substantially similar as the transaction for which an IRS Form 8918 has been filed.¹³⁶

- The IRS will issue to a material advisor a “reportable transaction number” with respect to the disclosed reportable transaction. The material advisor is required to provide the reportable transaction number to all taxpayers for whom the material advisor acted in that capacity.¹³⁷ The taxpayers and material advisors who are provided with the reportable transaction number are required to include the number on all required disclosures with respect to the reportable transaction.¹³⁸
- The JOBS Act extended the statute of limitations with respect to a listed transaction that a participant does not properly disclose to the IRS until one year after the first date on which the IRS is furnished the required information either by the taxpayer or a material advisor in satisfaction of its list maintenance requirements. The extended statute of limitations is effective for taxable years with respect to which the period for assessing a deficiency did not expire before October 22, 2004.¹³⁹

¹³⁶ Treas. Reg. § 301.6111-3(d)(1). An incomplete Form 8918 containing a statement that information will be provided upon request is not considered a complete disclosure form under proposed regulations.

¹³⁷ Treas. Reg. § 301.6111-3(d)(2). In addition, the material adviser should provide the reportable transaction number to other material advisers for whom the material adviser acted in that capacity.

¹³⁸ Treas. Reg. § 1.6011-4(d).

¹³⁹ Act Sec. 814 of the JOBS Act, adding I.R.C. § 6501(c)(10). The exception to the statute of limitations under section 6501(c)(10) does not supplant or shorten any other applicable statute of limitations on assessment, including a statute of limitations that has been extended by agreement, or a limitations period relating to a false or fraudulent return. Rev. Proc. 2005-26, 2005-1 C.B. 965.

- If a taxpayer files a return for a year in which the taxpayer participated in an undisclosed listed transaction and the IRS has not previously received the required listing information from the material advisor, the statute of limitations on assessment with respect to that transaction will not expire earlier than one year after the later of (i) the date on which the taxpayer discloses the transaction, or (ii) the date on which the IRS receives a list from the material advisor.¹⁴⁰
- If a transaction is identified as a listed transaction or a transaction of interest after the date the taxpayer files a tax return for the taxable year the taxpayer participated in the transaction, the taxpayer must file a disclosure statement with OTSA within 90 calendar days after the date on which the transaction became a listed transaction or a transaction of interest, whether or not the taxpayer participated in the transaction in that subsequent year.¹⁴¹

¹⁴⁰ Rev. Proc. 2005-26, 2005-1 C.B. 965. A taxpayer discloses a transaction by submitting a Form 8886, with a cover letter as described in Revenue Procedure 2005-26, to the appropriate Internal Revenue Service Center and a copy to the OTSA for each year in which the taxpayer participated in an undisclosed listed transaction. A taxpayer will not be deemed to have disclosed a transaction until both the Internal Revenue Service Center and OTSA have received the appropriate disclosure documents. A taxpayer under examination by the IRS or under Appeals consideration must also disclose in this manner any undisclosed listed transactions for any taxable year under consideration.

¹⁴¹ Treas. Reg. § 1.6011-4(e)(2)(i). If the obligation to disclose a post-filing listed transaction arises after the expiration of the period of limitations on assessment for a taxable year in which the taxpayer participated in the post-filing listed transaction, section 6501(c)(10) will not reopen or extend the limitations period. However, if the limitations period on assessment has not expired, and the taxpayer fails to disclose the post-filing listed transaction as required by the regulations under section 6011, the limitations period on assessment with respect to the undisclosed listed transaction will not expire earlier than one year after the taxpayer discloses the transaction. Rev. Proc. 2005-26, 2005-1 C.B. 965.

V. PENALTIES

A. Participant Penalties for Failing to Disclose a Reportable Transaction

- Prior to the enactment of the JOBS Act, no specific penalty was imposed on a participant for failure to disclose a reportable transaction in accordance with section 6011.
- The JOBS Act significantly modified the tax shelter penalty landscape. Effective for disclosure statements required to be attached to an original or amended return filed after October 22, 2004 (with a copy sent to the Office of Tax Shelter Analysis), regardless of whether the original return was due before October 22, 2004, the penalty for failing to disclose a reportable transaction is \$50,000 (\$200,000 with respect to a listed transaction), and \$10,000 in the case of individuals (\$100,000 with respect to a listed transaction).¹⁴²
- A reportable transaction disclosure statement is due upon the filing of an original or amended return reflecting the taxpayer's participation in a reportable transaction and therefore a penalty will not be imposed until a taxpayer fails to include the required statement with its return or provide the statement to the Office of Tax Shelter Analysis.¹⁴³
- The penalty applies regardless of whether the taxpayer's position is sustained on the merits¹⁴⁴ and may be imposed in addition to any accuracy related penalties.¹⁴⁵
- The IRS has indicated in interim guidance that it will impose a penalty with respect to each failure to (i) attach a reportable transaction disclosure

¹⁴² I.R.C. § 6707A, as added by the JOBS Act.

¹⁴³ Notice 2005-11, 2005-1 C.B. 493.

¹⁴⁴ H.R. Rep. No. 108-548, pt 1.

¹⁴⁵ I.R.C. § 6707A(f), as added by the JOBS Act.

statement to an original or amended return, or (ii) provide a copy of a disclosure statement to the Office of Tax Shelter Analysis, if required.¹⁴⁶

- However, a taxpayer that fails to attach the disclosure statement to an original or amended return and fails to provide a copy of a required disclosure statement to the Office of Tax Shelter Analysis will only be subject to a single penalty.¹⁴⁷
- The IRS Commissioner may rescind the penalty with respect to a reportable transaction that is not a listed transaction only if rescinding the penalty would promote compliance with the tax laws and effective tax administration.¹⁴⁸
 - In determining whether to rescind the penalty, the IRS Commissioner may take into account whether (i) the person on whom the penalty is imposed has a history of complying with the tax laws, (ii) the violation is due to an unintentional mistake of fact, and (iii) imposing the penalty would be against equity and good conscience.¹⁴⁹
 - The IRS has provided guidance to taxpayers who desire to request a penalty rescission including the (i) procedure for requesting rescission, (ii) the information the person must

¹⁴⁶ Notice 2005-11, 2005-1 C.B. 493.

¹⁴⁷ Notice 2005-11, 2005-1 C.B. 493.

¹⁴⁸ I.R.C. § 6707A(d), as added by the JOBS Act. The authority to rescind the penalty is exercisable only by the IRS Commissioner. H.R. Rep. No. 108-548, pt. 1. The IRS must (i) document any decision to rescind a penalty, including a description of the facts and reasons for the rescission and the amount rescinded, and (ii) submit an annual report to Congress summarizing the application of the disclosure penalties and describing each penalty rescinded and the reasons therefore. I.R.C. §§ 6707A(d) and 811(d), as added by the JOBS Act. A taxpayer may not judicially appeal the IRS's refusal to rescind a penalty. I.R.C. § 6707A(d), as added by the JOBS Act.

¹⁴⁹ H.R. Conf. No. 108-755.

provide in the request, and (iii) the factors that weigh in favor of and against granting rescission.¹⁵⁰

- The IRS may not rescind the penalty with respect to a listed transaction.¹⁵¹
- Public entities required to pay a penalty for failing to disclose a listed transaction, or subject to an understatement or gross valuation misstatement penalty attributable to a non-disclosed reportable transaction, must disclose the penalty in a report to the SEC, regardless of whether the penalty is material to the report.¹⁵²
- Failure to disclose the penalty in an SEC report as required is treated as a failure to disclose a listed transaction.¹⁵³

B. Material Advisor Penalties for Failing to Maintain an Investor List

- Under prior law, the penalty for failing to maintain an investor list as required by section 6112 was \$50 for each name that was required to have been on the list, subject to a maximum penalty of \$100,000 per year.¹⁵⁴
- The JOBS Act substantially increased this penalty. Following enactment of the JOBS Act, any material advisor who is required to maintain an investor list that fails to make the list available upon written

¹⁵⁰ Rev. Proc. 2007-21, 2007-9 I.R.B. 613.

¹⁵¹ I.R.C. § 6707A(d), as added by the JOBS Act.

¹⁵² I.R.C. § 6707A(e), as added by the JOBS Act; Rev. Proc. 2005-51, 2005-2 C.B. 296. A disclosure on Form 10-K must include (i) the amount of any penalty, (ii) whether the penalty has been paid in full, (iii) the Code section and subparagraph under which the penalty was determined, and (iv) a description of the penalty. Rev. Proc. 2005-51, 2005-2 C.B. 296.

¹⁵³ I.R.C. § 6707A(e), as added by the JOBS Act.

¹⁵⁴ I.R.C. § 6708(a), prior to amendment by the JOBS Act.

request by the IRS within 20 business days after the request will be subject to a \$10,000 per day penalty.¹⁵⁵

- The IRS may waive the penalty if the failure to make the list available is due to reasonable cause.¹⁵⁶ However, the failure to maintain a list does not constitute reasonable cause.¹⁵⁷
- Notably, the IRS may impose the penalty with respect to any request for a material advisor's list that is made after October 22, 2004, including requests for lists with respect to transactions that occurred before such date.

C. Material Advisor Penalties for Failing to Disclose a Reportable Transaction

- The JOBS Act instituted a new reportable transaction disclosure requirement for material advisors. A material advisor who fails to file an information return, or who files a false or incomplete information return in compliance with the new regime, is subject to a penalty of:
 - \$50,000 with respect to a reportable transaction that is not a listed transaction, or
 - with respect to a listed transaction, the greater of (i) \$200,000 or (ii) 50% of the advisor's gross income attributable to aid, assistance, or advice provided with respect to the transaction before the date the information return that includes the transaction is filed (75% in the case of intentional disregard).¹⁵⁸
- The IRS Commissioner may rescind the penalty with respect to a reportable transaction that is not a

¹⁵⁵ I.R.C. § 6708(a), as amended by the JOBS Act.

¹⁵⁶ I.R.C. § 6708(a), as amended by the JOBS Act.

¹⁵⁷ H.R. Rep. No. 108-548.

¹⁵⁸ I.R.C. § 6707(a) and (b), as amended by the JOBS Act.

listed transaction only if rescinding the penalty would promote compliance with the tax laws and effective tax administration.¹⁵⁹

- In determining whether to rescind the penalty the IRS may take into account whether (i) the person on whom the penalty is imposed has a history of complying with the tax laws, (ii) the violation is due to an unintentional mistake of fact, and (iii) imposing the penalty would be against equity and good conscience.
- The IRS may not rescind a penalty with respect to a listed transaction.¹⁶⁰
- The penalty applies to returns due after October 22, 2004.¹⁶¹

D. Tax Shelter Promoter Penalties

- The IRS may impose a penalty on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes:
 - a statement concerning the allowance of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or

¹⁵⁹ I.R.C. § 6707(c) (cross-referencing I.R.C. § 6707A(d)), as amended by the JOBS Act. The IRS must (i) document any decision to rescind a penalty including a description of the facts and reasons for the rescission and the amount rescinded and (ii) submit an annual report to Congress summarizing the application of the disclosure penalties and describing each penalty rescinded and the reasons therefore. A Taxpayer may not judicially appeal the IRS's refusal to rescind a penalty.

¹⁶⁰ I.R.C. § 6707(c) (cross-referencing I.R.C. § 6707A(d)), as amended by the JOBS Act.

¹⁶¹ Act. Sec. 816(c) of the JOBS Act.

participating in the plan or arrangement, which the person knows or has reason to know is false or fraudulent as to any material matter (a “false tax benefit statement”).¹⁶²

- Under prior law, the penalty with respect to any of these activities was equal to the lesser of \$1,000 or 100% of the gross income derived from the activity.¹⁶³
- The JOBS Act increased the penalty for false tax benefit statements with respect to activities occurring after October 22, 2004 concerning any material matter to an amount equal to 50% of the gross income derived by the person from the activity for which the penalty is imposed.¹⁶⁴

E. Modification of Actions to Enjoin Certain Conduct

- Under prior law, the IRS was authorized to bring civil actions to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.¹⁶⁵
- Effective October 23, 2004, the JOBS Act expanded the IRS’s authority to include the ability to seek injunctions (i) against a material advisor for failing to file an information return with respect to a reportable transaction, (ii) against a material advisor for failing to maintain, or to timely furnish upon written request by the IRS, a list of investors with respect to each reportable transaction, or (iii) with respect to violations of Circular 230.¹⁶⁶

¹⁶² I.R.C. § 6700(a).

¹⁶³ I.R.C. § 6700(a), prior to amendment by the JOBS Act.

¹⁶⁴ I.R.C. § 6700(a), as amended by the JOBS Act.

¹⁶⁵ I.R.C. § 7408.

¹⁶⁶ I.R.C. § 7408(c), as amended by the JOBS Act.

F. Tax Shelter Exception to Taxpayer Communication Confidentiality Privileges

- In general, a taxpayer is entitled to treat certain communications with its tax advisor as privileged. This privilege, however, does not apply to any written communication between a corporate taxpayer (or representative of a corporate taxpayer) and its federally authorized tax practitioner in connection with the promotion of the direct or indirect participation of the corporation in a tax shelter.¹⁶⁷
- The JOBS Act expanded the exception to a taxpayer's privilege expectation to include all written communication with respect to a tax shelter that takes place on or after October 22, 2004 between all taxpayers (including non-corporate taxpayers) and the taxpayer's federally authorized tax practitioner.¹⁶⁸

G. Accuracy-Related Penalty for Reportable Transactions

- Section 6662 generally imposes an accuracy-related penalty of 20% of the understatement of tax resulting from an incorrect tax return position (i) due to negligence, disregard of the rules or regulations, or certain substantial misstatements or overstatements of value, basis, or liabilities, or (ii) that gives rise to a "substantial understatement" of tax (generally the greater of 10% of the tax required to be shown on the taxpayer's return or \$5,000 (\$10,000 in the case of a corporation)).¹⁶⁹

¹⁶⁷ I.R.C. § 7525, prior to amendment by the JOBS Act.

¹⁶⁸ I.R.C. § 7525, as amended by the JOBS Act.

¹⁶⁹ I.R.C. § 6662(a). Under section 6662(d) an amount of an understatement can be reduced if there was substantial authority for the position taken by a taxpayer or if the facts affecting an item's tax treatment are adequately disclosed and there was a reasonable basis for the position taken. The IRS has provided guidance for determining when disclosure is adequate to reduce an amount of an

- Under prior law, an individual taxpayer (but not a corporate taxpayer) could avoid an accuracy-related penalty attributable to an abusive tax shelter by demonstrating that (i) there was substantial authority for the tax treatment of the tax shelter item, and (ii) the individual reasonably believed that the tax treatment reported was more-likely-than-not the proper treatment.¹⁷⁰
- The accuracy-related penalty attributable to an abusive tax shelter could also be abated under prior law for both individual and corporate taxpayers if the taxpayer could demonstrate that (i) there was reasonable cause for the underpayment, and (ii) the taxpayer acted in good faith. Reasonable cause would exist where the taxpayer reasonably relied on the opinion of a tax advisor that the tax treatment of the transaction had a more than 50% chance of being upheld if challenged by the IRS.¹⁷¹
- Effective for taxable years ending after October 22, 2004, the JOBS Act modifies the accuracy-related penalty provisions applicable to tax shelters by adding a new accuracy-related penalty regime under new section 6662A that applies to reportable transactions.

understatement under section 6662(d). Rev. Proc. 2008-14, I.R.B. 2008-7. According to the revenue procedure, for disclosure to reduce an understatement (i) money amounts entered on a return must be verifiable, (ii) the taxpayer must clearly describe any items on a return that do not already have a preprinted description identifying the items, and (iii) positions taken on the return must have a reasonable basis. Further, the disclosure will not reduce the understatement amount if (i) the item disclosed is attributable to a tax shelter, (ii) the item is not substantiated, or (iii) the taxpayer failed to keep adequate books and records with respect to the item or position. Finally, disclosure is not adequate to reduce an understatement amount if the understatement arises from a transaction between related parties.

¹⁷⁰ I.R.C. § 6662(d)(2)(C); Treas. Reg. § 1.6662-4(g)(1)(i).

¹⁷¹ Treas. Reg. §§ 1.6662-4(g)(4)(i)(B) and 1.6664-4(c) and (f).

- An abusive tax shelter was broadly defined for purposes of the accuracy-related penalties under prior law as a partnership or other entity, any investment plan or other arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax.¹⁷²
- The accuracy-related penalty provisions in new section 6662A apply to reportable transactions as defined in Treasury regulation section 1.6011-4.¹⁷³
- In addition, the accuracy-related penalty as modified by the JOBS Act imposes a 30% penalty on any understatement attributable to a reportable transaction that a taxpayer failed to adequately disclose in accordance with the participant reportable transaction disclosure requirements.¹⁷⁴ There are no exceptions to this penalty.¹⁷⁵
- Alternatively, a lesser 20% accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed reportable transaction.
- A taxpayer may avoid the 20% penalty by demonstrating that (i) there was reasonable cause for the understatement, and (ii) the taxpayer acted in good faith. Reasonable cause and good faith require a taxpayer to:

¹⁷² I.R.C. § 6662(d)(2)(C).

¹⁷³ Reportable transactions include (i) listed transactions, (ii) confidential transactions, (iii) loss transactions, (iv) contractual protection transactions, (v) transactions giving rise to a significant book-tax difference, and (vi) brief holding period tax-credit transactions. Treas. Reg. § 1.6011-4(b).

¹⁷⁴ I.R.C. § 6662A(c).

¹⁷⁵ Notice 2005-12, 2005-1 C.B. 494.

- have adequately disclosed the relevant facts affecting the tax treatment of the transaction under section 6011,
- demonstrate that there was substantial authority for the claimed tax treatment of the transaction, and
- demonstrate that it reasonably believed that the claimed tax treatment was more likely than not the proper treatment.¹⁷⁶
 - A taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief:
 - is based on the facts and law that exist at the time the tax return including the item was filed, and
 - relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (i) a return will not be audited, (ii) the treatment will not be raised on audit, or (iii) the treatment

¹⁷⁶ I.R.C. § 6664(d)(2). The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. More specifically, the amount of the understatement is determined as the sum of (i) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return), and (ii) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. I.R.C. § 6662A(b)(1). Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted regarding an examination of the return or such other date as specified by the IRS. I.R.C. § 6662A(e)(3).

will be resolved through settlement if raised.¹⁷⁷

- A taxpayer may (but is not required to) rely on an opinion of a tax advisor to establish reasonable belief with respect to the tax treatment of an item. However, a taxpayer may not rely on an opinion that:
 - is provided by a “disqualified tax advisor”,
 - is based on unreasonable factual or legal assumptions (including assumptions as to future events),
 - unreasonably relies upon representations, statements, finding or agreements of the taxpayer or any other person,
 - does not identify and consider all relevant facts, or
 - fails to meet any other requirement prescribed by the IRS.¹⁷⁸
- A disqualified tax advisor is any advisor who:
 - is a material advisor and who participates in the organization,¹⁷⁹

¹⁷⁷ I.R.C. § 6664(d)(3)(A).

¹⁷⁸ Notice 2005-12, 2005-1 C.B. 494.

¹⁷⁹ Participating in the “organization” of a transaction includes (i) devising, creating, investigating or initiating the transaction or tax strategy, (ii) devising the business or financial plans for the transaction or tax strategy, (iii) carrying out those plans through negotiations or transactions with others, or (iv) performing acts relating to the development of the transaction. Performing acts relating to the development or establishment of a transaction may include, for example, preparing documents (i) establishing a

management,¹⁸⁰ promotion¹⁸¹ or sale of the transaction or is related to any person who so participates,¹⁸²

- is compensated directly or indirectly by a material advisor with respect to the transaction under a referral fee or fee sharing arrangement a

structure used in connection with the transaction (such as a partnership agreement or articles of incorporation), (ii) describing the transaction (such as an offering memorandum, tax opinion, prospectus or other document describing the transaction), or (iii) registering the transaction with any federal, state or local government body. Notice 2005-12, 2005-1 C.B. 494.

¹⁸⁰ Participating in the “management” of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction, including managing assets, directing business activity, or acting as general partner, trustee, director or officer of an entity involved in a transaction. Notice 2005-12, 2005-1 C.B. 494.

¹⁸¹ Participating in the “promotion or sale” of a transaction means involvement in the marketing or solicitation of the transaction or tax strategy, including (i) soliciting, directly or through an agent, taxpayers to enter into a transaction or tax strategy using direct contact, mail, telephone or other means, (ii) placing an advertisement, or (iii) instructing or advising others with respect to marketing the transaction or tax strategy. Notice 2005-12, 2005-1 C.B. 494. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

¹⁸² A tax advisor whose only involvement in a transaction consists of rendering a tax opinion regarding the tax consequences of the transaction will not be treated as participating in the organization, management, promotion or sale of a transaction. The tax advisor may suggest modifications to the transaction, but may not suggest material modifications to the transaction that assist the taxpayer in obtaining the anticipated tax benefits. Notice 2005-12, 2005-1 C.B. 494. The performance of support services or ministerial functions, including typing, photocopying or printing will not be considered participating in the organization, management, promotion or sale of a transaction. Notice 2005-12, 2005-1 C.B. 494.

“disqualified compensation arrangement”,¹⁸³

- has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, including agreements providing that (i) a taxpayer has the right to a full or partial refund of fees if all or part of the tax consequences from the transaction are not sustained, or (ii) the amount of the fee is contingent on the taxpayer’s realization of tax benefits from the transaction, or
- as determined under regulations, has a disqualifying financial interest with respect to the transaction.
- The portion of an understatement upon which a penalty is imposed under 6662A is not subject to the accuracy-related penalty under section 6662. However, any such understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). This penalty does not apply to any portion of an understatement to which a fraud penalty is applied under section 6663 or for which the rate of penalty is calculated under section

¹⁸³ In addition, an arrangement will be treated as a disqualified compensation arrangement if there is an agreement or understanding (oral or written) with a material advisor of a reportable transaction pursuant to which the tax advisor is expected to render a favorable opinion regarding the tax treatment of the transaction to any person referred by the material advisor. A tax advisor will not be treated as having a disqualified compensation arrangement if a material advisor merely recommends the tax advisor who does not have an agreement or understanding with the material advisor to render a favorable opinion regarding the tax treatment of a transaction. Notice 2005-12, 2005-1 C.B. 494.

6662(h) in the case of gross valuation misstatements.¹⁸⁴

H. Tax Return Preparer Penalties for Understatement Of Taxpayer's Liability

- Section 6694(a), as amended by the Emergency Economic Stabilization Act of 2008, generally provides that a “tax return preparer” that prepares any return or claim of refund with respect to which any part of an understatement of liability is due to an “unreasonable position” and knew (or reasonably should have known) of the position is subject to a penalty.¹⁸⁵ No penalty under Section 6694(a) is

¹⁸⁴ I.R.C. § 6662A(e).

¹⁸⁵ The section 6694 tax return preparer penalty provision has a long and winding history. As originally enacted in 1976, section 6694 subjected an income tax return preparer to a penalty if the preparer engaged in (1) a negligent or intentional disregard of the tax law, rules, or regulations in an attempt to understate a taxpayer's tax liability or (2) a willful attempt to understate a taxpayer's tax liability, either of which led to an understatement of tax liability. Tax Reform Act of 1976, Pub. L. No. 94-455 (1976). The section was added to the Code to deter the growing number of income tax return preparers from engaging in improper conduct. *See* General Explanation of the Tax Reform Act of 1976, Pub. L. No. 94-455 (1976).

The tax return preparer penalty rules under section 6694(a) were amended in 1989 to impose a higher standard for preparer penalties. Under the revised standard, income tax return preparers would not be subject to penalties unless (1) the preparer knew or reasonably should have known of a position on the return that did not have a realistic possibility of being sustained on the merits if it were examined by the IRS, (2) any part of an understatement of liability was due to the position, and (3) the position was not adequately disclosed or was frivolous. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 (1989). For background on the decision to reform the section 6694 penalty provisions in 1989, as well as a detailed analysis of the exemptions allowed under this Act, *see* Harvey L. Coustan and Sheldon I. Banoff, *Dodging the Bullet: Avoiding the Accuracy-Related and Preparer Penalties Through Reasonable Cause and Good Faith, or Disclosure*, 69 TAXES 351 (June 1991).

imposed if there is a reasonable cause for the understatement and the tax return preparer acted in good faith.¹⁸⁶

- Under current law, a position will only be considered an “unreasonable position” if:
 - (1) the position is a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, and the preparer does not reasonably believe that the position would more likely than not be sustained on the merit, or¹⁸⁷

Under the Small Business and Work Opportunity Act of 2007 (the “2007 Act”), section 6694(a) was again amended to subject all tax return preparers (not just income tax return preparers) to a penalty for an understatement of liability if the tax return preparer knew or should have known of a position that the preparer did not reasonably believe was more likely than not to be sustained on its merits, unless the position was adequately disclosed and there was a reasonable basis for the opinion. Small Business and Work Opportunity Act of 2007, Pub. L. No. 110-28 (2007). Notice 2007-54, 2007-27 I.R.B. 12. These 2007 Act changes made it easier for tax return preparers to get caught in the section 6694(a) penalty provision.

Finally, on October 3, 2008, the Emergency Economic Stabilization Act of 2008 (“EESA”) once again revised the penalty provisions applicable to tax return preparers to lower the standard from the relatively high more likely than not to be sustained on its merits requirement, to a substantial authority requirement. However, the EESA also introduced a new, separate standard for positions that are tax shelters (as defined in section 6662(d)(2)(C)(ii)) or reportable transactions to which section 6662A applies, which retained the more likely than not standard of certainty. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 (2008).

¹⁸⁶ I.R.C. § 6694(a)(3). Factors that will be considered in determining whether an understatement was due to reasonable cause and good faith include the complexity of the error causing the understatement, the frequency of errors, the materiality of the error, the preparer’s normal office practice, reliance on advice of others and reliance on generally accepted administrative or industry practice. Treas. Reg. § 1.6694-2(e).

¹⁸⁷ I.R.C. § 6694(a). Treas. Reg. § 1.6694-2(a)(1). The new standard for positions that are not tax shelters or reportable transactions

(2) in all other cases, the position

(a) is not either supported by
substantial authority or

applies to all returns prepared after May 25, 2007; the standard for tax shelter and reportable transaction positions applies to returns prepared for taxable years ended after October 3, 2008. Notice 2009-5, 2009-3 I.R.B. 309.

The penalty applies to an understatement of liability, which exists if there is an understatement of the net amount payable with respect to any tax imposed by the Code or an overstatement of the net amount creditable or refundable with respect to any tax imposed by the Code. Treas. Reg. § 1.6694-1(c). If a penalty is assessed against a tax return preparer, and a final administrative determination or a final judicial decision later establishes that there was no understatement of liability relating to the position on the return or claim for refund, the assessment will be abated and any penalty paid will be refunded as if the payment were an overpayment of tax, without consideration of any period of limitations. Treas. Reg. § 1.6694-1(d).

The revisions to section 6694 included in the Emergency Economic Stabilization Act of 2008 have generally been welcomed by tax practitioners because they reduce the standard for avoiding the penalties for non-tax shelter and reportable transactions. However, retention of the more likely than not standard for tax shelters and reportable transactions has caused some practitioners to express concern that the retention of the more likely than not standard for tax shelters and reportable transactions will lead to conflict between taxpayers and tax preparers, because tax preparers may be motivated to take conservative positions in preparing tax returns, in order to avoid potential penalties. See Richard M. Lipton and Robert S. Walton, *Tax Return Preparer Penalty Final Regulations*, 110 J. TAX'N 229 (April 2009).

For a thorough overview of the Section 6694 penalties, see Charles P. Rettig, *Practitioner Penalties: Potential Pitfalls in the Tax Trenches*, 2009 TNT 69-12 (April 13, 2009). For a detailed discussion of the history of, and recent changes to, section 6694, see Richard M. Lipton and Robert S. Walton, *Tax Return Preparer Penalty Final Regulations*, 110 J. TAX'N 229 (April 2009); see also, *Preparer Penalty Changed Again, This Time Mostly for the Better*, 110 J. TAX'N 62 (Sheldon I. Banoff and Richard M. Lipton eds., Jan. 2009).

(b) adequately disclosed (or disclosed without any reasonable basis for the disclosed position).

- The substantial authority standard is an objective standard that is less stringent than the more likely than not standard (which is only met if there is a greater than 50% likelihood of the position being upheld), but more stringent than the reasonable basis standard (as described below).¹⁸⁸ Substantial authority generally exists if the weight of the authorities supporting the treatment are substantial in relation to the weight of authorities supporting contrary treatment. The weight accorded to any authority must be considered in light of its relevance, persuasiveness, and the type of document providing the authority. Only certain types of authorities may be considered authority for purposes of determining whether there is substantial authority for the tax treatment of an item.¹⁸⁹

¹⁸⁸ Treas. Reg. § 1.6662-4(d)(2). Substantial authority, for purposes of section 6694(a), has the same definition as in Treasury regulations section 1.6662-4(d)(2). Notice 2009-5, 2009-3 I.R.B. 309.

¹⁸⁹ Treas. Reg. § 1.6662-4(d)(3). Appropriate authorities include the following: the Code; regulations; revenue rulings and revenue procedures; tax treaties and their official explanations; court cases; congressional intent; the Blue Book; private letter rulings and technical advice memoranda; actions on decisions and general counsel memoranda; IRS information or press releases; and administrative pronouncements published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-4(d)(3)(iii).

Substantial authority also exists for a position that is supported by the conclusion of a ruling or determination letter issued to the taxpayer, by the conclusion of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in the revenue agent's report with respect to a prior taxable year of the taxpayer (each, a "written determination"), unless the written determination contained a misstatement or omission of material fact about which the tax return preparer knew or should have known. Notice 2009-5, 2009-3 I.R.B. 309; Treas. Reg. § 1.6662-4(d)(3)(iv)(A).

- A reasonable basis for a position exists if the return position is reasonably based on one or more appropriate authorities, taking into consideration the relevance and persuasiveness of the authorities and any subsequent developments.¹⁹⁰
- Reasonable basis is a standard of tax reporting, that is, significantly higher than not frivolous or not patently improper and it is not satisfied by a return position that is merely arguable or that is merely a colorable claim.¹⁹¹ For purposes of determining whether a tax return preparer has a reasonable basis for the position, the preparer may rely in good faith upon information furnished by the taxpayer, as well as information and advice furnished by another advisor, another tax return preparer, or other party.¹⁹²

Substantial authority for a position is tested as of the date the return or claim for refund is deemed prepared. Notice 2009-5, 2009-3 I.R.B. 309.

¹⁹⁰ Treas. Reg. § 1.6694-2(d)(2). The authorities that are appropriate for determining whether there is a reasonable basis for a position are the same as the appropriate authorities for determining whether substantial authority exists (as discussed above). Treas. Reg. § 1.6662-4(d)(3)(iii).

¹⁹¹ Treas. Reg. § 1.6662-3(b)(3).

¹⁹² Treas. Reg. § 1.6694-2(d)(2). In order to meet the good faith standard, a tax return preparer is not required to audit, examine or review books and records, business operations, documents, or other evidence to independently verify information provided by the taxpayer, advisor, other tax return preparer, or other party who the tax return preparer has reason to believe is competent to render the advice or information. The tax return preparer may also rely in good faith without verification upon a tax return that has been previously prepared and filed with the IRS (although the preparer must confirm that the position being relied upon has not been adjusted by examination or otherwise). However, the tax return preparer may not ignore the implications of information provided to the preparer or actually known by the preparer, and the preparer must make reasonable inquiries if any information provided appears to be

- Treasury regulations set forth the requirements necessary to satisfy the adequate disclosure exception to the understatement penalty.¹⁹³ In general, nonsigning and signing income tax return preparers are subject to different disclosure obligations.
 - A signing tax return preparer is the preparer who has the primary responsibility for the overall substantive accuracy of the preparation of the return or claim for refund.¹⁹⁴
 - A nonsigning tax return preparer is any preparer who is not a signing preparer but who prepares all or a substantial portion of a return or claim for refund with respect to events that have occurred when the advice is rendered.¹⁹⁵

incorrect or incomplete. The advice or information may be written or oral. The tax return preparer is not considered to have relied in good faith if the advice or information is unreasonable on its face, the preparer knew or should have known that the other party providing the advice or information was not aware of all relevant facts, or the preparer knew or should have known at the time the return or claim for refund was prepared that the advice or information was no longer reliable due to developments in the law since the time the advice was given. Treas. Reg. §§ 1.6694-1(e) and 1.6694-2(e)(5).

¹⁹³ Treas. Reg. § 1.6694-2(d)(3).

¹⁹⁴ Treas. Reg. § 301.7701-15(b)(1).

¹⁹⁵ Treas. Reg. § 301.7701-15(b)(2)(i). The regulations provide a safe harbor, which provides that in determining whether a preparer qualifies as a nonsigning tax return preparer, time spent on advice given after the events have occurred will not be taken into account if it represents less than 5% of the aggregate time incurred by the individual with respect to the position giving rise to the understatement. However, an anti-abuse rule provides that notwithstanding the 5% safe harbor time spent on advice given before the events occurred will be taken into account if all facts and circumstances demonstrate that (i) the positions giving rise to the understatement are primarily attributable to the advice, (ii) the advice was substantially given before events occurred primarily to avoid

- In the case of a signing tax return preparer, disclosure is generally considered adequate if (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R attached to the return or to a qualified amended return (or in accordance with a specified annual revenue procedure), (2) the tax return preparer provides the taxpayer with a prepared tax return that discloses the position on a properly completed Form 8275 or Form 8275-R attached to the return or to a qualified amended return (or in accordance with a specified annual revenue procedure), or (3) for returns or claims for refund that are subject to certain penalties pursuant to section 6662, the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section

treating the advisor as a tax return preparer, and (iii) the advice was confirmed after events had occurred for purposes of preparing a tax return. Treas. Reg. § 301.7701-15(b)(2)(i). The IRS has indicated that there “is no movement to expand” the 5% safe harbor. *See Jeremiah Coder, Don’t Expect Preparer Penalty Safe Harbor to be Expanded, Treasury Official Says*, 2009 TNT 9-5 (Jan. 15, 2009).

Previously, under Treas. Reg. § 1.6694-1(b)(2), a “nonsigning” preparer was defined as any preparer who was not a signing preparer, *e.g.*, one who provides advice to a taxpayer. A “signing” preparer was any preparer who signed a return or refund claim as a preparer. If more than one preparer was involved in the preparation of a tax return, the preparer with the primary responsibility for the overall substantive accuracy of the return was required to sign it. Treas. Reg. § 1.6695-1(b).

One IRS official has described the application of section 6694 to nonsigning preparers as a “huge policy issue.” *See Final Section 6694 Preparer Penalty Guidance Coming Later in the Year, Says IRS Official*, 2008 TNT 21-4 (Jan. 30, 2008). Another IRS official has stated that removing nonsigning preparers from the ambit of section 6694 might inequitably put too much pressure on signing preparers. *See News Analysis: New Preparer Penalties Sweep Away Circular 230*, 2008 TNT 24-8 (Jan. 31, 2008).

6662 and contemporaneously documents the advice in the tax return preparer's files.¹⁹⁶

- In the case of a nonsigning tax return preparer, disclosure is generally considered adequate if the position is disclosed on a properly completed Form 8275 or Form 8275-R attached to the return or to a qualified amended return (or in accordance with a specified annual revenue procedure).¹⁹⁷
- In addition, if the tax return preparer provides advice to the taxpayer (as compared to another tax return preparer), adequate disclosure also requires the tax return preparer to advise the taxpayer of any relevant opportunity to avoid any section 6662 penalties that could apply to the position and of any applicable standards for disclosure to the extent applicable, and contemporaneously document the advice in the tax return preparer's files.¹⁹⁸
- Alternatively, if the tax return preparer provides advice to another tax return

¹⁹⁶ Treas. Reg. § 1.6694-2(d)(3)(i). The tax return preparer must inform the taxpayer of any penalties imposed under section 6662 that apply to an underpayment of tax that is attributable to one or more of the following: negligence or disregard of rules or regulations; any substantial valuation misstatement under chapter 1; any substantial overstatement of pension liabilities; or any substantial estate or gift tax valuation understatement.

In order to satisfy this disclosure requirement, each return position for which there is a reasonable basis but for which there is not substantial authority must be addressed by the tax return preparer and the advice must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances. Treas. Reg. § 1.6694-2(d)(3)(iii).

¹⁹⁷ Treas. Reg. § 1.6694-2(d)(3)(ii).

¹⁹⁸ Treas. Reg. § 1.6694-2(d)(3)(ii)(A).

preparer (as opposed to the taxpayer), adequate disclosure requires the tax return preparer to advise the other tax return preparer that disclosure may be required under section 6694(a) and contemporaneously document the advice in the tax return preparer's files.¹⁹⁹

- In determining whether the standard has been met for a tax shelter or reportable transaction position, a tax return preparer's belief that tax treatment of an item meets the more likely than not standard is reasonable if the preparer analyzes the pertinent facts and authorities and, in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50% likelihood that the tax treatment of the position will be upheld on the merits if challenged by the IRS.²⁰⁰ In addition, neither the audit lottery nor probability that an issue will be settled may not be taken into account for

¹⁹⁹ Treas. Reg. § 1.6694-2(d)(3)(ii)(B). Penalties may be imposed under section 6662 due to an underpayment of tax that is attributable to one or more of the following: negligence or disregard of rules or regulations; any substantial understatement of tax; any substantial valuation misstatement under chapter 1; any substantial overstatement of pension liabilities; or any substantial estate or gift tax valuation understatement. Section 6662.

Revenue Procedure 2008-14 also provides guidance with respect to what constitutes adequate disclosure on a taxpayer's return for purposes of avoiding the section 6694(a) penalty. *See* Rev. Proc. 2008-14, 2008-7 I.R.B. 435.

²⁰⁰ Treas. Reg. 1.6694-2(b)(1).

The preparer must analyze the pertinent facts and authorities in a manner described in Treasury regulation section 1.6662-4(d)(3)(ii). Accordingly, the weight given to a particular authority depends on the type of document, the age of the document, and the relevance and persuasiveness of the document providing the authority.

Reasonable basis standard is interpreted in accordance with Treasury regulation section 1.6662-3(b)(3), as described above. Notice 2008-13, 2008-3 I.R.B. 282.

purposes of determining whether a position meets the standard.²⁰¹

- The tax return preparer may rely in good faith without verification upon information furnished by the taxpayer and/or other third party, consistent with Treasury regulation sections 1.6694-1(e) and 1.6694-2(e)(5)²⁰² to determine whether the preparer has a reasonable belief that a position is more likely than not to be sustained on the merits.²⁰³
- Accordingly, the tax return preparer is not required to independently verify information furnished by the taxpayer or another party. However, the preparer may not ignore the implications of information furnished or actually known to the preparer, and must make reasonable inquiries if the information furnished by another tax return preparer or a third party appears to be incorrect or incomplete.²⁰⁴
- In addition, the tax return preparer who prepares an amended return or claim for refund is not required to verify the positions on the original return.²⁰⁵
- Query whether requiring a tax return preparer to analyze all pertinent authorities

²⁰¹ Treas. Reg. 1.6694-2(b)(1).

²⁰² The good faith standards of Treasury regulation sections 1.6694-1(e) and 1.6694-2(e)(5) are discussed in footnote 192, *supra*.

²⁰³ Treas. Reg. § 1.6694-2(b)(1).

²⁰⁴ Treas. Reg. § 1.6694-1(e)(1). In addition, a tax return preparer must make appropriate inquiries to determine the existence of facts and circumstances required by the Code or regulations as a condition for claiming a deduction or credit. Treas. Reg. § 1.6694-1(e)(2). *See* Treas. Reg. § 1.6694-1(e)(3), *examples* 1, 2, and 3.

²⁰⁵ Treas. Reg. § 1.6694-1(e)(2).

is an exceedingly burdensome requirement, especially if the taxpayer is not willing to pay for exhaustive research.

- A “tax return preparer” potentially subject to penalties under section 6694 generally includes any person who, for compensation, prepares or employs others to prepare, all or a “substantial portion” of any tax return or refund claim,²⁰⁶ regardless of such person’s educational qualifications, professional status, nationality, residence or place of business.²⁰⁷

²⁰⁶ Generally, a return or claim for refund for these purposes includes returns and claims for refunds that are specifically identified in published guidance in the Internal Revenue Bulletin. Treas. Reg. 301.7701-15(b)(4). Simultaneously with the issuance of the final regulations, the IRS issued Revenue Procedure 2009-11, which identifies categories of returns to which the penalty under section 6694 could apply. See Rev. Proc. 2009-11, 2009-3 I.R.B. 313 (identifying relevant categories of tax returns and claims for refund for purposes of the section 6694 and 6695 penalties).

²⁰⁷ I.R.C. § 7701(a)(36). Treas. Reg. § 301.7701-15(d) and (e).

Whether a schedule, entry or other portion of a return is substantial is determined based upon whether the person rendering the tax advice knows or reasonably should know that the tax attributable to such portion of the return or claim for refund is a substantial portion of the tax required to be shown on the return or claim for refund. Treas. Reg. 301.7701-15(b)(3)(i). The regulations identify the following factors to be considered in determining whether a portion of a return is substantial: (i) the size and complexity of the item relative to the taxpayer’s gross income; and (ii) the size of the understatement attributable to the item compared to the taxpayer’s reported tax liability. Treas. Reg. 301.7701-15(b)(3). The regulations contain a *de minimis* rule for nonsigning tax return preparers. Generally, under the *de minimis* rule, a schedule, entry or other portion of a return is not considered to be a substantial portion if it involves amounts of gross income, deductions or amounts on the basis of which credits are determined that are less than (i) \$10,000 or (ii) \$400,000 and also less than 20% of gross income (or adjusted gross income, for individuals), based on an aggregate of all of the work performed. Treas. Reg. § 301.7701-15(b)(3)(ii)(A), (B) and (C).

The final regulations raised the threshold for an item to be treated as a substantial portion of a return or claim for a refund. Previously, whether a portion was substantial depended on the relative size of the deficiency attributable to the portion in question. A “substantial

- A person that renders tax advice on a position (such as a tax advisor on specific issues of law) is not a tax return preparer, unless the advice (i) covers events which have occurred at the time advice is rendered, and (ii) is directly relevant to the determination of the existence, characterization, or amount of any entry on a return or refund claim.²⁰⁸ This exception is generally intended to except certain lawyers that provide tax advice.²⁰⁹
- An individual is a tax return preparer subject to section 6694 if the individual is primarily responsible for the position on the return or claim for refund giving rise to an understatement, whether or not such individual was the signing preparer.²¹⁰
- Only one individual within a firm can be held primarily responsible for each refund or claim position on a return.²¹¹ However, where multiple firms were engaged to work on a return or claim position, more than one tax return

portion” was a schedule, entry, or other portion of a tax return or refund claim that, if adjusted or disallowed, could result in a deficiency determination (or refund claim disallowance) that the preparer knew or reasonably should have known was a significant portion of the tax liability reported on the return (or, in the case of a refund claim, a significant portion of the tax originally reported). Notice 2008-13, 2008-3 I.R.B. 282.

²⁰⁸ See Treas. Reg. § 301.7701-15(b)(2) and (3).

Commentators have suggested that section 6694 should not apply to someone who never drafts, reviews, or discusses the actual return. See N.Y. St. B.A. Tax Sec., *Report on the Definition of “Tax Return Preparer” and Other Issues Under Code Sections 6694, 6695 and 7701(a)(36)* (Dec. 20, 2007).

²⁰⁹ See Treas. Reg. § 301.7701-15(b)(2)(ii), *examples* 1, 2, and 3.

²¹⁰ Treas. Reg. § 1.6694-1(b)(1).

²¹¹ Treas. Reg. § 1.6694-1(b)(1). This rule, which was included in the final regulations modified the existing rule, provided that only the signing preparer was treated as the tax return preparer.

preparer may be held primarily responsible for the position.²¹²

- Subject to certain exceptions, the signing tax return preparer generally will be considered the person primarily responsible for all return or claim positions giving rise to an understatement.²¹³
- Both an individual and the firm that employs or is associated with the individual may be subject to penalty under section 6694 with respect to a position giving rise to an understatement.²¹⁴
 - A firm that employs or is associated with a tax return preparer subject to a penalty under section 6694(a) is also subject to penalty if, and only if, (i) any member of the principal management (or principal officers) of the firm or a branch office participated in or knew of the prohibited conduct; (ii) the firm failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or (iii) the firm disregarded its reasonable and appropriate review procedures through

²¹² Treas. Reg. § 1.6694-1(b)(1).

²¹³ Treas. Reg. § 1.6694-1(b)(2). If there is no signing tax return preparer for the return or claim for refund within the firm, or if it is concluded that the signing tax return preparer is not primarily responsible for the position, the nonsigning tax return preparer within the firm with overall supervisory responsibility for the position giving rise to the understatement generally will be considered the tax return preparer who is primarily responsible for the position unless, based upon credible information from any source, it is concluded that another nonsigning tax return preparer within that firm is primarily responsible for the position giving rise to the understatement. Treas. Reg. § 1.6694-1(b)(3). If either the signing tax return preparer or a nonsigning tax return preparer is primarily responsible for a position giving rise to an understatement, the penalty may be assessed against either one of the individuals, but not both. Treas. Reg. § 1.6694-1(b)(4).

²¹⁴ Treas. Reg. § 1.6694-1(b)(5).

willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) in the formulation of the advice, or the preparation of the return or claim for refund that included the position for which the penalty is imposed.²¹⁵

- The penalty for violating section 6694 is the greater of 50 percent of the “income derived (or to be derived)” by the tax return preparer with respect to the return or refund claim, or \$1,000.²¹⁶
 - Income derived (or to be derived) by the tax return preparer includes all compensation received or expected to be received with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position taken on the return or claim.²¹⁷
 - If a tax return preparer is not compensated directly by the taxpayer, but instead by a firm that employs or is associated with the tax return preparer, then income derived (or to be derived) includes all compensation the tax return preparer receives from the firm that can

²¹⁵ Treas. Reg. § 1.6694-2(a)(2).

²¹⁶ A similar penalty is imposed on any tax return preparer who prepares any return or claim for refund with respect to which any part of an understatement of liability is due to a willful attempt to understate the liability for tax on the return or claim, or a reckless or intentional disregard of rules or regulations. I.R.C. § 6694(b). The penalty is the greater of \$5,000 or 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim. I.R.C. § 6694(b)(1).

²¹⁷ Treas. Reg. § 1.6694-1(f).

be reasonably allocated to the engagement.²¹⁸

- If a firm that employs or is associated with an individual tax return preparer is subject to a penalty, then the income derived (or to be derived) means all compensation the firm receives or expects to receive with respect to the engagement.²¹⁹
- If the tax return preparer or the tax return preparer's firm has multiple engagements related to the same return or claim for refund, only those engagements relating to the positions giving rise to the understatement are considered for purposes of determining the income derived.²²⁰
- Only compensation for tax advice that is given with respect to events that have occurred at the time of the advice is rendered and that relates to the position giving rise to the understatement are taken into account for purposes of calculating the penalties.²²¹
- Income received in the form of a lump sum is allocated between tax advice giving rise to a penalty and advice that does not give rise to a penalty.²²²

²¹⁸ Treas. Reg. § 1.6694-1(f).

²¹⁹ Treas. Reg. § 1.6694-1(f).

²²⁰ Treas. Reg. § 1.6694-1(f)(2).

²²¹ Treas. Reg. § 1.6694-1(f)(2)(ii).

²²² Treas. Reg. § 1.6694-1(f)(2)(ii). Refunds to the taxpayer of all or part of the amount paid to the tax return preparer or its firm will not reduce the amount of any assessed penalty. Treas. Reg. § 1.6694-1(f)(2)(iii).

- If less than the total amount of compensation received by a tax return preparer or its firm with respect to an engagement is attributable to the position giving rise to the understatement on a return or claim for a refund, then the amount of the penalty will be calculated based upon the portion of the compensation attributable to the position giving rise to the understatement.²²³
- If both an individual within a firm and a firm that employs or is associated with the individual are subject to a penalty, the amount of penalties assessed against the individual and the firm cannot exceed 50% of the income derived (or to be derived) by the firm from the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the positions taken on the return or claim for refund that gave rise to the understatement. Moreover, the portion of the total amount of the penalty assessed against the individual tax return preparer cannot exceed 50% of the individual's compensation with respect to the engagement.²²⁴

VI. FINAL CIRCULAR 230 REGULATIONS

A. Overview

- Congress granted the Treasury Department the authority to “regulate the practice of representatives of persons before the Department of the Treasury”. The Treasury Department originally issued regulations governing the practice of attorneys (and others) practicing before the IRS in Treasury Department Circular No. 230 (“Circular 230”) 35

²²³ Treas. Reg. § 1.6694-1(f)(2)(iv).

²²⁴ Treas. Reg. § 1.6694-1(f)(3).

years ago. Over the past few years the IRS has proposed several revisions to the Circular 230 regulations to address the problem of tax shelters. On December 20, 2004, the IRS appeared to culminate its efforts with its publication of the final Circular 230 regulations. However, the final Circular 230 regulations published in December 2004 were met with a firestorm of criticism from practitioners.²²⁵ In an attempt to address certain practitioner comments highlighting areas where the language of the final regulations could result in consequences inconsistent with its intent, the IRS issued a new set of final regulations revising the December 2004 Circular 230 regulations in May, 2005.

- The final Circular 230 regulations seek to accomplish three goals:
 - Establish “best practices” for “tax advisors” providing tax advice;
 - Set forth the requirements for practitioners providing “covered” opinions;
 - Set forth the requirements for practitioners providing written advice that is not a covered opinion; and
 - Provide compliance procedures for persons with responsibility for overseeing a firm’s tax practice.

B. Scope of Circular 230

- A threshold question is whether Circular 230’s regulation of written tax advice exceeds its authority. As mentioned above, pursuant to its authority to “regulate the practice of representatives of persons before the Department of the

²²⁵ See e.g., N.Y. St. B.A. Tax Sec., *Report on Circular 230 Regulations* (Mar. 3, 2005).

Treasury,²²⁶ Treasury issued regulations governing the practice of attorneys, CPAs, actuaries, enrolled agents and other persons practicing before the IRS in Treasury Department.²²⁷

- “Practice” before the IRS includes all matters connected with a presentation to the IRS relating to a taxpayer’s rights, privileges, or limitations under laws or regulations administered by the IRS.²²⁸
- An attorney may practice before the IRS by filing with the IRS a written declaration that he or she is currently qualified as an attorney and is authorized to represent the party or parties on whose behalf he or she acts.²²⁹ This person is a “practitioner” for purposes of the Circular 230 regulations.²³⁰
- Prior to the enactment of the JOBS Act many practitioners questioned whether a tax attorney or an accountant who has not filed a written declaration with the IRS is a practitioner under Circular 230²³¹ and whether the Circular 230

²²⁶ 31 U.S.C. § 330(a)(1).

²²⁷ Circular 230, 31 C.F.R. pt. 10 (hereinafter, “Cir. 230” or “Circular 230”).

²²⁸ Cir. 230 § 10.2(d). This includes, but is not limited to, preparing and filing documents, communicating with the IRS, and representing clients at conferences, hearings and meetings.

²²⁹ Cir. 230 § 10.3(a).

²³⁰ Cir. 230 § 10.2(e). The attorney may not currently be under suspension or disbarment from practice before the IRS.

²³¹ According to former IRS Chief Counsel B. John Williams Jr., “[i]f you’re not practicing before the agency then the agency is not licensing your practice I don’t know any other agency where the federal government seeks to reach out and grab the practice of opinion giving.” Sheppard and Stratton, *News Analysis: Williams Advocates Tax Accrual Workpaper Policy Changes*, 101 TNT 323 (Oct. 20, 2003). However, provisions confirming the IRS’s power to regulate opinions and impose monetary penalties have been proposed in legislation that has passed both the House and Senate. *See*

regulations apply to an attorney or an accountant who will never appear before the IRS.

- The regulations issued in September, 2007 provide that attorneys and accountants who render written advice governed by Circular 230 section 10.35 or 10.37 are practicing before the IRS even if the practitioners do not file a written declaration with the IRS.²³²
- The JOBS Act confirms the IRS's position that it has the authority to regulate written advice with respect to tax shelters and allows the IRS to sanction tax practitioners through censure and the imposition of monetary penalties.²³³
- Failure to comply with the final Circular 230 regulations (other than with respect to best practices) is subject to censure, suspension or disbarment from practice before the IRS.²³⁴

Stratton, *Opinion Standards to be Finalized Soon, Treasury Official Says*, 2004 TNT 61-4 (Mar. 29, 2004).

²³² Cir. 230 § 10.3(a), (b).

²³³ See Act Sec. 882(b) of the JOBS Act, amending 31 U.S.C. § 330(d).

²³⁴ A practitioner may also be subject to sanctions for incompetence and disreputable conduct, including conviction of any criminal offense under the Federal tax laws or involving dishonesty, misappropriation of funds received from a client for the purpose of payment of taxes due the United States, and other actions. Cir. 230 §§ 10.50(a), 10.51(a). The regulations list a total of fifteen examples of incompetence and disreputable conduct for which a practitioner may be sanctioned, but provide no general definition of incompetence and disreputable conduct.

The Guide to Sanctions, released by the IRS's Office of Professional Responsibility, provides direction for determining which corrective sanction (censure, suspension, or disbarment) is appropriate for particular Circular 230 violations. See Internal Revenue Service, *IRS Releases Guide To Practitioner Sanctions*, 2009 TNT 83-13 (May 1, 2009); available at http://www.irs.gov/pub/irs/utl/newly_revised_final_tax-non_compliance_sanction_guidelines_3.pdf.

1. Contingent Fees

- September, 2007 Circular 230 regulations prohibit a practitioner from charging contingent fees for services rendered in connection with any matter before the IRS, except with respect to:²³⁵
 - An IRS examination of, or challenge to, (i) an original tax return, or (ii) an amended return or claim for refund filed before or within 120 days after the taxpayer receives a written notice of the examination or a written challenge to the original tax return;
 - A claim for credit or refund filed solely with respect to statutory interest or penalties assessed by the IRS;
 - A whistleblower claim under section 7623; and
 - A judicial proceeding arising under the Internal Revenue Code.

2. Conflicting Interests

- September, 2007 Circular 230 regulations prohibit a practitioner from representing a client before the IRS if (i) the representation will be directly adverse to another client, or (ii) there is a significant risk that the representation will be materially limited by the practitioner's (x) personal interest, or (y) responsibilities to another client, a former client, or a third person.²³⁶
 - A practitioner may represent a client despite a conflict of interest, provided (i) the practitioner

²³⁵ Cir. 230 § 10.27(b), *as clarified by* Notice 2008-43, 2008-15 I.R.B. 748. A “contingent fee” means any fee wholly or partially based on whether or not a position taken on a tax return or other filing avoids a challenge by the IRS or is sustained in litigation (including any fee arrangement including the practitioner reimbursing the client in the event a position is challenged or is not sustained).

²³⁶ Cir. 230 § 10.29(a).

reasonably believes that the practitioner is able to provide competent and diligent representation to each affected client, (ii) the representation is not prohibited by law, and (iii) each affected client waives the conflict of interest by giving informed consent in writing within 30 days of being informed of the conflict by the practitioner.²³⁷

3. Proposed Tax Return Preparer Regulations

- Proposed Circular 230 regulations would subject a practitioner to sanctions if the practitioner advises a client to take a position on a tax return, or prepares the portion of a tax return on which a position is taken that the practitioner does not reasonably believe satisfies the more likely than not standard, unless the position has a reasonable basis and is adequately disclosed to the IRS.²³⁸
- A practitioner would satisfy the reasonable belief standard if the practitioner reasonably concludes on the basis of analyzing pertinent

²³⁷ Cir. 230 § 10.29(b). The practitioner must retain copies of the written consents for 36 months. Cir. 230 § 10.29(c).

The preamble to Circular 230 section 10.29 states that a practitioner would not be subject to a sanction or a monetary penalty because of the client's failure to provide written consent to the practitioner if the practitioner has documented its good faith effort to obtain the written consent, and the practitioner promptly withdraws from the conflicted representation within a reasonable period. *See* T.D. 9359, 2007 TNT 187-9 (Sept. 25, 2007).

²³⁸ Prop. Cir. 230 § 10.34(a). Thus, the proposed regulations would apply a stricter standard than the standard set out in section 6694(a) when advising with respect to tax return positions and preparing or signing returns.

The American Bar Association has recommended revising section 10.34(a) of Circular 230 to subject practitioners to the requirements of section 6694 of the Code in light of the new section 6694(a) standards, and in order to achieve a level of conformity between Circular 230 and section 6694. *See* Stuart M. Lewis, *ABA Members Seek Reproposed Guidance on Post-2007 Changes to Circular 230*, 2009 TNT 106-15 (June 5, 2009).

facts and authority that there is a greater than 50% likelihood that the IRS would lose a challenge of the tax treatment.²³⁹ A position would have a reasonable basis if it is reasonably based on one or more authorities in Treasury regulation section 1.6662-4(d)(3)(iii). The proposed regulations clarify that a reasonable basis is a relatively high standard of tax reporting, which is (i) significantly higher than not frivolous or patently improper, and (ii) not met by a merely arguable position or a colorable claim. In addition, the audit lottery (or the probability that an issue will be settled) may not be taken into account for the purposes of determining whether a position has a reasonable basis.

- The government has indicated that Circular 230 section 10.34 professional standards should conform with the civil penalty standards for return preparers.²⁴⁰ This seemingly straightforward position raises several questions.²⁴¹

²³⁹ Prop. Cir. 230 § 10.34(e).

²⁴⁰ REG-138637-07, 2007 TNT 186-7 (Sept. 24, 2007). However, according to Carolyn Gray, acting deputy director in IRS's Office of Professional Responsibility, the focus of Circular 230 is to examine a practitioner's fitness to practice, which apparently is sufficient reason for Circular 230 section 10.34 to "cast the net wider" than section 6694. *See Daily Tax Report*, May 23, 2008, at G-4.

Following the most recent changes to section 6694, however, a number of differences exist between the Circular 230 section 10.34 standards and the civil penalty standards of section 6694. *See* Stuart M. Lewis, *ABA Members Seek Reproposed Guidance on Post-2007 Changes to Circular 230*, 2009 TNT 106-15 (June 5, 2009) (discussing the important differences between the two sets of standards, and recommending that the Treasury and the IRS reevaluate the proposed Circular 230 regulations, taking into consideration these differences).

²⁴¹ Commentators have sought clarification on a number of issues raised by proposed Circular 230 section 10.34, including (i) what type and scope of activities will subject practitioners to sanction, and (ii) what constitutes "reasonable belief." *See* N.Y. St. B.A. Tax Sec., *Report*

- Query whether the rules provided in the Treasury regulations for section 6694, especially with regard to tax return preparer's disclosure obligations, should apply for the purposes of Circular 230 section 10.34.
- Query whether Circular 230 section 10.34 standards should conform with taxpayer standards in section 6662 rather than with the return preparer standards in section 6694.

C. Monetary Penalties for Non-Compliance

- The JOBS Act amended Circular 230 to permit the IRS to impose monetary penalties on a tax practitioner and a tax practitioner's employer, firm, or other entity that knew, or reasonably should have known, of the practitioner's conduct.²⁴² The amount of any monetary penalty is limited to the gross income derived (or to be derived) from the conduct giving rise to the penalty and could be imposed in addition to, or in lieu of, any suspension, disbarment, or ensure of the practitioner.²⁴³
- Subsequently, Notice 2007-39 and then Circular 230 regulations have each provided guidance with respect to monetary penalties.²⁴⁴ As commentators have noted, this guidance appears to be inconsistent in some respects.²⁴⁵

on the Proposed Amendments to Circular 230 Relating to Standards with Respect to Tax Returns (Jan. 29, 2008).

²⁴² See Act Sec. 882(b) of the JOBS Act. The expanded sanctions included in the JOBS Act may be imposed on actions taken after October 22, 2004. See Act Sec. 882(a)(2) of the JOBS Act.

²⁴³ See Act Sec. 882(a)(1) of the JOBS Act, amending 31 U.S.C. § 330(b).

²⁴⁴ Notice 2007-39, 2007-20 I.R.B. 1243; Cir. 230 § 10.50(c).

²⁴⁵ See Letter from Stanley L. Blend, Chair, American Bar Association Section of Taxation, to Linda Stiff, Acting Commissioner, Internal Revenue Service (Oct. 5, 2007) (the phrase used by the Notice, "in

- Notice 2007-39 and Circular 230 section 10.50 both cover the same subject matter,²⁴⁶ and while the preamble to Circular 230 section 10.50 mentions the Notice, it does not address whether the Notice has continuing effect.²⁴⁷

1. Circular 230 Regulations

- September, 2007 Circular 230 regulations impose a monetary penalty for incompetence or disrepute, failure to comply with certain Circular 230 regulations, and willfully and knowingly misleading or threatening a client or a prospective client with intent to defraud.²⁴⁸ The penalty is limited to the gross income derived (or to be derived) from the conduct giving rise to the penalty.²⁴⁹
- Monetary penalties may be imposed on (i) any practitioner engaging in the proscribed conduct, and (ii) any employer (or other entity) on whose behalf the practitioner was acting in connection with the proscribed conduct, provided the

connection with such prohibited conduct,” may be construed more broadly than the phrase used by the statute and the Circular 230 regulation section 10.50, “derived from the conduct”). Without expressing a view as to the correctness of this statement, we observe that the scope of a Notice would logically be limited by both statutory and regulatory language.

²⁴⁶ See Letter from Stanley L. Blend, Chair, American Bar Association Section of Taxation, to Linda Stiff, Acting Commissioner, Internal Revenue Service (Oct. 5, 2007) (arguing that the Notice should be incorporated into the Circular 230 regulations). In addition, commentators asked for clarity as to when the monetary penalty might be appropriate, for example, when or how the mitigating factors are to be taken into account.

²⁴⁷ T.D. 9359, 2007 TNT 187-9 (Sept. 25, 2007).

²⁴⁸ Cir. 230 § 10.50(a).

²⁴⁹ Cir. 230 § 10.50(c)(2).

employer knew or reasonably should have known of the misconduct.²⁵⁰

2. Notice 2007-39

- Notice 2007-39 limits the amount of monetary penalties that may be imposed to the collective gross income derived by the practitioner and other persons in connection with the prohibited conduct.²⁵¹
 - The notice describes the facts and circumstances that will determine the amount of the penalty. These include the practitioner's level of culpability; whether there was a violation of duty owed to a client or prospective client; the actual or potential injury caused by the violation. Mitigating factors may include prompt action to correct the noncompliance, promptly ceasing to engage in the prohibited conduct; rectifying the harm caused by the prohibited conduct; and taking preventive measures to avoid repetition of the prohibited conduct in the future.²⁵²
- If a practitioner acted on behalf of employer (or any other entity) which knew or reasonably should have known of the employee's

²⁵⁰ Cir. 230 § 10.50(c). In addition, (i) monetary penalties may be imposed on both the practitioner and the employer, and (ii) monetary penalties may be imposed on a practitioner in addition to any of the other sanctions sanctioned by the regulations, including suspension, disbarment, and censure.

²⁵¹ Notice 2007-39, 2007-20 I.R.B. 1243. If the act of prohibited conduct giving rise to a penalty is an integral part of a larger engagement, the amount of the penalty is limited by the income derived from the larger engagement.

²⁵² Notice 2007-39, 2007-20 I.R.B. 1243. Penalties determined by reference to income derived both before and after October 22, 2004 are pro-rated to exclude amounts attributable to conduct occurring on or before October 22, 2004.

prohibited conduct, the employer may be subject to a separate monetary penalty.²⁵³

- An employer knows or reasonably should know of the prohibited conduct if (i) a principal manager or officer of the employer or a branch office (x) knows of the prohibited conduct, or (y) has information from which a person with similar experience and background would reasonably know of the prohibited conduct, or (ii) the employer through willfulness, recklessness, or gross indifference fails to take reasonable steps to ensure compliance with Circular 230, and an individual, in connection with the agency relationship with the employer, engages in (A) prohibited conduct under Circular 230 section 10.52 that harms a client, the public, or tax administration, or (B) a pattern or practice of failing to comply with Circular 230.²⁵⁴

²⁵³ Cir. 230 § 10.50(c)(1)(ii); Notice 2007-39, 2007-20 I.R.B. 1243. A practitioner acts on behalf of employer (or any other entity) if (i) the practitioner and the employer have an agency relationship, the purpose of which is to provide services in connection with practice before the IRS under Circular 230 section 10.2(d), and (ii) the prohibited conduct arises in connection with the agency relationship.

Other factors that may be relevant to determining whether a monetary penalty should appropriately be imposed on an employer include (i) the gravity of the misconduct, (ii) any history of noncompliance by the employer, (iii) preventative measures in effect prior to the misconduct's occurrence, and (iv) any corrective measures taken by the employer after it discovers the misconduct.

²⁵⁴ Notice 2007-39, 2007-20 I.R.B. 1243. Failure to take reasonable steps to ensure compliance with Circular 230 through willfulness, recklessness, or gross indifference includes ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain.

D. Recommended Best Practices for Tax Advisors

- The final Circular 230 regulations provide that “tax advisors”²⁵⁵ should adhere to certain best practices set forth below, and that the tax advisors with oversight responsibility for a firm’s tax practice should take reasonable steps to ensure that their firm’s procedures for members and other employees are consistent with the following best practices:²⁵⁶
 - Communicate clearly with clients regarding the terms of an engagement (*e.g.*, determine the purpose for and use of the advice and have a clear understanding regarding the form and scope of the advice).²⁵⁷
 - Establish the relevant facts and evaluate the reasonableness of assumptions or representations.²⁵⁸
 - Relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts and arrive at a conclusion supported by the law and the facts.²⁵⁹
 - Advise clients regarding the importance of the conclusions reached (*e.g.*, whether taxpayer can avoid substantial understatement penalties if it relies on the advice).²⁶⁰
 - Act fairly and with integrity in practice before the IRS.²⁶¹

²⁵⁵ The final Circular 230 regulations do not define the term “tax advisor.”

²⁵⁶ Cir. 230 § 10.33(b).

²⁵⁷ Cir. 230 § 10.33(a)(1).

²⁵⁸ Cir. 230 § 10.33(a)(2).

²⁵⁹ Cir. 230 § 10.33(a)(2).

²⁶⁰ Cir. 230 § 10.33(a)(3).

²⁶¹ Cir. 230 § 10.33(a)(4).

- The preamble to the final regulations clarifies that these best practices are aspirational. Failure to comply with the best practices will not subject a practitioner to discipline under the regulations.

E. Opinion Requirements under the Final Circular 230 Regulations

- The final Circular 230 regulations generally employ a two prong system whereby “covered opinions,” which are subject to extensive requirements and necessitate substantially more detailed analysis, can provide penalty protection, while “other written advice,” which is subject to less extensive rules, cannot protect a taxpayer from penalties. The system is effectively policed through the requirement that the consequences of various opinions be “prominently disclosed”.
- Prominent disclosure requires, at a minimum, that the text be set forth in a separate section (and not in a footnote) in a typeface that is the same size or larger than the type face of any discussion of the facts or law in the written advice.²⁶² An item is prominently disclosed if it is readily apparent to a reader of the written advice, which will depend on the facts and circumstances surrounding the written advice, including the sophistication of the reader and the length of the advice.²⁶³
- IRS officials have repeatedly acknowledged that the current requirements for written advice are too broad. A working group of Treasury and IRS officials is analyzing whether to amend the current rules-based approach or replace the current section 10.35 with a “standards-based” approach similar to the approach taken by ethics rules. Section 10.35 could be amended either by

²⁶² Cir. 230 § 10.35(b)(8).

²⁶³ Cir. 230 § 10.35(b)(8).

complete revision or by providing further guidance in the form of clarifying notices and revenue procedures.

1. Description of Covered Opinions

- A covered opinion is written advice (including email) by a practitioner concerning a federal tax issue that arises from:
 - a listed transaction,
 - any plan or arrangement the principal purpose of which is the avoidance or evasion of tax imposed by the Code (a “principal purpose tax avoidance transaction”), or
 - any plan or arrangement, a significant purpose of which is the avoidance or evasion of tax imposed by the Code (a “significant purpose tax avoidance transaction”), if the written advice is:
 - a reliance opinion,
 - a marketed opinion,
 - subject to conditions of confidentiality, or
 - subject to contractual protection.²⁶⁴
- The Circular 230 regulations issued in December 2004 did not make clear what types of transactions (*e.g.*, like-kind exchanges, stock purchases with section 338(h)(10) elections and acquisitions structured to qualify as tax-free reorganizations) would constitute principal purpose tax avoidance transactions. In response to commentators’ requests for clarification, the Treasury Decision promulgating revised Circular 230 regulations in May, 2005 provides that for purposes of Circular 230, the meaning of “the principal purpose” is similar to the definition of such phrase found in

²⁶⁴ Cir. 230 § 10.35(b)(2).

Treasury regulation section 1.6662-4(g)(2)(ii).²⁶⁵ More specifically, the revised regulations provide that the principal purpose of a plan or arrangement is avoiding or evading any tax imposed by the Internal Revenue Code if that purpose exceeds any other purpose, but not if its purpose is the claiming of tax benefits in a manner consistent with the statute and Congressional purpose.²⁶⁶

- Curiously, in defining the phrase “the principal purpose,” the revised regulations did not exclude transactions the purpose of which is the claiming of tax benefits in a manner consistent with Treasury regulations or Revenue Rulings. Query whether taxpayers could nonetheless successfully argue that Treasury regulations and Revenue Rulings provide evidence of Congressional purpose.
- Query whether written advice provided to a non-U.S. entity with respect to structuring transactions so as to completely avoid payment of U.S. tax may fall outside the scope of written advice concerning a principal purpose tax avoidance transaction.
- The Circular 230 regulations also do not define what constitutes a “significant purpose”. For example, it is not clear whether structuring a transaction that would otherwise occur for good business reasons in a tax-efficient manner could constitute a significant tax avoidance purpose.²⁶⁷
- A federal tax issue includes the federal tax treatment of any item of income, gain, loss, deduction or credit, the taxable transfer or a non-

²⁶⁵ T.D. 9201, 2005-1 C.B. 1153.

²⁶⁶ Cir. 230 § 10.35(b)(10).

²⁶⁷ An IRS official recently acknowledged that the “significant purpose” definition is “too broad.” “Namorato Says Service’s Study Group To Consider Changing Circular 230 Rules,” *Daily Tax Report*, Mar. 6, 2006, at G-9.

transfer of property, or the value of property for federal tax purposes.²⁶⁸

- A reliance opinion is written advice that concludes that one or more significant federal tax issues would be resolved favorably for the taxpayer at a confidence level of “at least more likely than not.”²⁶⁹
 - Presumably a reliance opinion also includes a “should” opinion and perhaps any “will” opinion that the IRS would have a reasonable basis to challenge (as discussed below).
 - A significant federal tax issue is a federal tax issue that the IRS has a reasonable basis to successfully challenge and whose resolution could have a significant impact (beneficial or adverse) under any reasonably foreseeable circumstance on the overall federal tax treatment of the matter addressed in the written advice.²⁷⁰
 - Although the final Circular 230 regulations do not attach any percentage to a reasonable basis for success standard, commentators have equated a reasonable basis for success with a 10-25% chance of success.²⁷¹ The accuracy-related penalty regulations define reasonable

²⁶⁸ Cir. 230 § 10.35(b)(3).

²⁶⁹ Cir. 230 § 10.35(b)(4).

²⁷⁰ Cir. 230 § 10.35(b)(3).

²⁷¹ See Banoff and Coustan, *Final Regulations on Return Preparer Penalties*, 70 TAXES 137, 176 (1992) (reasonable basis is generally a 10-20% likelihood of success); Wolfman, Holden, and Schenk, *Ethical Problems in Federal Tax Practice*, p. 42 (Little, Brown 3d ed. 1995) (reasonable basis is generally a 20-25% likelihood of success); Raby, *Reasonable Basis vs. Other Opinion Standards*, 73 TNT 1209, (Dec. 9, 1996) (reasonable basis is generally a 15-20% likelihood of success); Charles P. Rettig, *Practitioner Penalties: Potential Pitfalls in the Tax Trenches*, 2009 TNT 69-12 (April 13, 2009) (reasonable basis is generally a 20-25% likelihood of success).

basis as, “a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper,” which is “not satisfied by a return position that is merely arguable or that is merely a colorable claim.”²⁷² Further, a return position reasonably based on one or more “substantial authorities” (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), generally satisfies the reasonable basis standard.²⁷³

²⁷² Treas. Reg. § 1.6662-3(b)(3). *See also* Treas. Reg. § 301.6111-2(b)(4) (reasonable basis standard is not satisfied by an IRS position that would be merely arguable or that would constitute merely a colorable claim).

²⁷³ Treas. Reg. § 1.6662-3(b)(3).

Substantial authorities include applicable provisions of the Code and other statutory provisions; proposed, temporary and final regulations; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill’s managers; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the “Blue Book”); PLRs and technical advice memoranda issued after October 31, 1976; actions on decisions and GCMs issued after March 12, 1981 (as well as certain pre-1955 published GCMs); IRS information and press releases; and published notices, announcements and other administrative pronouncements.

An authority does not so qualify if and to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority. For example, a district court opinion on an issue is not an authority if overruled or reversed by the United States Court of Appeals for such district. However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals. Similarly, a private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other published administrative pronouncement.

Treas. Reg. § 1.6662-4(d)(3)(iii).

- A marketed opinion is written advice a practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or another practitioner at his or her firm) to promote, market or recommend an arrangement.²⁷⁴

2. Requirements for Covered Opinions

- A covered opinion must identify and consider all relevant facts.²⁷⁵
- The opinion may not be based on unreasonable factual or legal assumptions, representations, statements or findings the practitioner knows or should know are incorrect or incomplete.²⁷⁶
 - The opinion may not assume a business purpose or a potential profit apart from tax benefits.²⁷⁷
 - The opinion may not rely on a taxpayer's factual representation of a business purpose that does not specifically describe the business purpose, or that the practitioner knows or should know is incorrect or incomplete.²⁷⁸ Although the regulations do not detail what sort of due diligence is contemplated with respect to business purposes, the "should know" standard seems to hold practitioners to a heightened level of knowledge regarding prevailing economic conditions.
 - The opinion must identify in a separate section all factual representations, statements or

²⁷⁴ Cir. 230 § 10.35(b)(5). An IRS official recently acknowledged that the "marketed opinion" definition is "too broad" and sweeps in "unintended and uncontroversial tax advice." "Namorato Says Service's Study Group To Consider Changing Circular 230 Rules," *Daily Tax Report*, Mar. 6, 2006, at G-9.

²⁷⁵ Cir. 230 § 10.35(c)(1).

²⁷⁶ Cir. 230 § 10.35(c)(1)(ii) and (iii).

²⁷⁷ Cir. 230 § 10.35(c)(1)(ii).

²⁷⁸ Cir. 230 § 10.35(c)(1)(ii).

findings of the taxpayer that the practitioner is relying upon.

- The opinion may not rely on a projection, financial forecast or appraisal the practitioner knows or should know is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare the projection, financial forecast or appraisal.²⁷⁹
- The opinion must relate the law (including potentially applicable judicial doctrines) to the relevant facts.²⁸⁰
 - The regulations do not explain what level of knowledge of potentially applicable judicial doctrines will be assumed, or how the potential applicability of such doctrines will be determined. For example, would a doctrine that the IRS continuously asserts without success on similar facts be considered potentially applicable?
 - The opinion may not assume the favorable resolution of any significant federal tax issue (unless the scope of the opinion is limited or the practitioner properly relies on another legal opinion) or otherwise be based on unreasonable legal assumptions, representations or conclusions.²⁸¹
 - The final regulations do not specify how the scope of potentially applicable legal doctrines is to be determined in the case of a limited scope opinion. Presumably doctrines relevant to a single issue being opined on must be addressed, but query whether step transaction and substance over form doctrines could potentially apply with

²⁷⁹ Cir. 230 § 10.35(c)(1)(ii).

²⁸⁰ Cir. 230 § 10.35(c)(2)(i).

²⁸¹ Cir. 230 § 10.35(c)(2)(ii).

respect to a limited scope opinion on a single issue, or transaction?

- The opinion may not include internally inconsistent legal analyses or conclusions.²⁸²
 - The opinion must consider all significant federal tax issues (unless the scope of the opinion is limited or the practitioner properly relies on another legal opinion),²⁸³ provide a conclusion as to the likelihood of success on the merits with respect to each significant federal tax issue considered, and describe the reasons for each conclusion (including the facts and analysis supporting each conclusion).²⁸⁴
 - The opinion may not take into account 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.²⁸⁵
- The opinion must provide an overall conclusion as to the likelihood that the federal tax treatment of the tax shelter items is proper together with the reasons for that conclusion.²⁸⁶
- A practitioner who is unable to reach a conclusion with respect to one or more significant federal tax issues (or an overall conclusion) must state and describe the reasons for the inability to reach a conclusion.²⁸⁷
 - As discussed below, if a practitioner is unable to reach a conclusion with respect to any

²⁸² Cir. 230 § 10.35(c)(2)(iii).

²⁸³ Cir. 230 § 10.35(c)(3)(ii).

²⁸⁴ Cir. 230 § 10.35(c)(3)(ii).

²⁸⁵ Cir. 230 § 10.35(c)(iii).

²⁸⁶ Cir. 230 § 10.35(c)(4).

²⁸⁷ Cir. 230 § 10.35(c)(4).

significant federal tax issue, the opinion cannot constitute a covered marketed opinion.

3. Required Disclosures for Covered Opinions

- All covered opinions must prominently disclose the existence of any compensation arrangement, referral agreement, referral fee, or fee-sharing arrangement between the practitioner (or another practitioner at the practitioner’s firm) and any promoter, other than the client for whom the opinion was prepared.²⁸⁸
- A covered opinion that fails to reach a conclusion of at least more likely than not with respect to any significant federal tax issue considered in the opinion (which, as discussed below, cannot be a covered marketed opinion) must “prominently disclose” that:
 - the opinion does not reach a conclusion at a confidence level of at least more likely than not with respect to a significant federal tax issue, and
 - with respect to that issue, the opinion was not written, and cannot be used by the taxpayer, to avoid penalties that may be imposed on the taxpayer.²⁸⁹
- A practitioner and taxpayer may agree to affirmatively limit the scope of a non-marketed covered opinion that does not address a listed or principal tax avoidance transaction, provided that the opinion prominently discloses that:
 - its scope is limited to the federal tax issues addressed in the opinion,
 - additional issues may exist that could affect the federal tax treatment of the transaction and the opinion does not consider or provide a

²⁸⁸ Cir. 230 § 10.35(e)(1).

²⁸⁹ Cir. 230 § 10.35(e)(4).

conclusion with respect to any additional issues,
and

- the opinion was not written, and cannot be used by the taxpayer, to avoid penalties on significant federal tax issues outside the opinion’s scope.²⁹⁰
- A covered marketed opinion must:
 - reach a conclusion of at least more likely than not with respect to each significant federal tax issue and reach an overall conclusion of at least more likely than not (thus, a covered marketed opinion cannot be limited in scope),²⁹¹ and
 - prominently disclose that:
 - the opinion was written to support the marketing of the transaction, and
 - the taxpayer should seek advice based on the taxpayer’s particular circumstances from an independent tax advisor.²⁹²
 - Note that under this test an opinion cannot qualify as a covered marketed opinion if it either fails to reach a more likely than not conclusion on one or more significant federal tax issues, or is otherwise affirmatively limited in scope. Instead, such an opinion would be subject to the rules for marketing opinions that constitute “other written advice.”
- 4. Opt Out Provisions & Other Exceptions to Covered Opinions
 - The final Circular 230 regulations permit a practitioner to opt out of the requirements for covered opinions in certain circumstances.

²⁹⁰ Cir. 230 § 10.35(e)(3).

²⁹¹ Cir. 230 § 10.35(c)(4)(ii).

²⁹² Cir. 230 § 10.35(e)(2).

- A practitioner may not opt out of the covered opinion rules if the written advice pertains to a:
 - listed transaction,
 - principal purpose tax avoidance transaction,
 - confidential transaction, or
 - contractual protection transaction.
- A practitioner may opt out of the covered opinion requirements only if:
 - the opinion is either a reliance opinion or a marketed opinion,
 - the written advice prominently discloses that the advice was not intended or written by the practitioner to be used, and cannot be used by the taxpayer, to avoid penalties, and
 - in the case of a marketed opinion, the opinion also prominently discloses that the advice was written to support the marketing of the arrangement, and that the taxpayer should seek advice from its own independent tax advisor (*i.e.*, it contains the same disclosure required for covered marketed opinions).²⁹³
 - Most practitioners have elected to automatically add opt out legends to all written advice, including all emails, in order to prevent inadvertent failures to comply with the requirements of Circular 230.²⁹⁴ This over-use

²⁹³ Cir. 230 § 10.35(b)(4)(ii) and (5)(ii).

²⁹⁴ The opt out legend included in our emails provides as follows:

IRS Circular 230 Notice: Any advice contained herein was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal, state, or local tax penalties. Unless otherwise specifically indicated above, you should assume that any statement in this email relating to any U.S. federal, state, or local tax matter was written in connection with the promotion or marketing by other

of the legend has had the effect of leading taxpayers to believe they are not penalty protected in cases not involving tax shelters where the IRS has no reasonable basis to challenge.²⁹⁵

- Other opinions that are exempt from the covered opinion rules include:
 - written advice provided to a client, if the practitioner reasonably expects to provide subsequent written advice to the client that satisfies the covered opinion requirements,
 - written advice not pertaining to a listed transaction or a principal purpose tax avoidance transaction that:
 - is included in documents required to be filed with the SEC,
 - concerns the qualification of a qualified plan, or
 - is a state or local bond opinion.
 - written advice provided to a taxpayer after the taxpayer has filed a tax return reflecting the tax benefits of the transaction, unless the practitioner knows or has reason to know the taxpayer (or someone else) will rely on that advice to take a position on a tax return

parties of the transaction(s) or matter(s) addressed in this email. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

²⁹⁵ "Opinions Under Circular 230: New Standards of Professionalism?", Presentation by Robert Cassanos to New York State Bar Association Tax Section, September 2004, *referred to in* Letter from the Tax Section of the New York State Bar Association to the IRS and the Department of the Treasury (May 1, 2006).

(including an amended return) filed after the date on which the advice is provided,²⁹⁶

- written advice provided to an employer by a practitioner acting in the capacity of an employee solely for purposes of determining the tax liability of the employer,²⁹⁷ and
- written advice concluding that a Federal tax issue will not be resolved in a taxpayer's favor in respect to a specific issue, unless the advice also reaches a conclusion favorable to the taxpayer at any level (*e.g.* not frivolous, realistic probability of success).²⁹⁸

²⁹⁶ The IRS added this exception in the revised final Circular 230 regulations issued in May 2005 in response to concern expressed by commentators that advice provided after a tax return had been filed, particularly in the context of an IRS examination or litigation, could constitute a covered opinion. *See* T.D. 9201, 2005-1 C.B. 1153.

²⁹⁷ The IRS added this exception in the revised final Circular 230 regulations issued in May 2005 to address the concern that written advice provided by in-house counsel to an employer for purposes of determining the employer's tax liability could constitute a covered opinion. The preamble to the May 2005 regulations provides that this exclusion is not intended to affect other aspects of the relationship between in-house counsel and the employer, such as whether, and in what circumstances, the attorney-client privilege applies to communications involving in-house counsel, or the circumstances in which written advice provided by in-house counsel might be relevant to determining the employer's good faith and reasonable cause reliance on such advice. T.D. 9201, 2005-1 C.B. 1153.

²⁹⁸ The preamble to the May 2005 regulations provides that the Treasury and the IRS are concerned about written advice that could be construed as encouraging taxpayers to take aggressive positions on their tax returns, such as advice that concludes one or more Federal tax issues will not be resolved in the taxpayer's favor, but also reaches a conclusion favorable to the taxpayer at any confidence level (*e.g.*, not frivolous, realistic possibility of success, reasonable basis or substantial authority) with respect to that issue. Accordingly, the revised final regulations provide that written advice that addresses more than one Federal tax issue must comply with the requirements for covered opinions with respect to each Federal tax issue with respect to which the opinion reaches a conclusion

- As discussed below, all written advice that is either exempt from the covered opinion rules, or not covered because the practitioner opts out of the rules, must comply with the requirements for other written advice (discussed below).²⁹⁹
5. Requirements for Other Written Advice Concerning Federal Tax Issues (i.e., Non-Covered Opinions)
- A practitioner must not provide written advice that:
 - is based on unreasonable factual or legal assumptions,
 - unreasonably relies on representations, statements, findings or agreements,
 - gives written advice that does not consider all relevant facts that the practitioner knows or should know, or
 - considers or relies on 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.³⁰⁰
 - In puzzling contrast to the above-described rules, the requirements for other written advice do not require that the written advice describe:
 - the relevant facts (including assumptions and representations),
 - the application of the law to those facts, or
 - the practitioner's conclusion with respect to the law and the facts.

favorable to the taxpayer at any confidence level. T.D. 9201, 2005-1 C.B. 1153.

Cir. 230 § 10.35(b)(2)(ii)(A)-(E).

²⁹⁹ Cir. 230 § 10.35(f)(2).

³⁰⁰ Cir. 230 § 10.37(a).

- In determining whether a practitioner has complied with the rules regarding other written advice, the IRS will consider all facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client.³⁰¹
- A heightened standard of care will apply with respect to non-covered marketed opinions because of the greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.³⁰²
- The rules for other written advice appear to suffer from internal inconsistencies. Consider, for example, the requirement that advice must consider all relevant facts that the practitioner knows or should know, together with the statement that the practitioner need not describe the relevant facts or the application of the law to the facts, or state a conclusion with respect to the law and facts.

F. Compliance Procedures

- The final Circular 230 regulations require a practitioner with principal authority and oversight responsibility for a firm's federal tax practice to take reasonable steps to ensure adequate firm procedures for all members, associates, and employees (*e.g.*, counsel) to comply with the requirements for covered opinions. Such practitioners will be disciplined for failure, due to willfulness, recklessness, or gross incompetence, to:³⁰³
- take reasonable steps to ensure the firm has adequate procedures to comply with the requirements for covered opinions, in the event a member, associate or employee of the firm

³⁰¹ Cir. 230 § 10.37(a)

³⁰² Cir. 230 § 10.37(a).

³⁰³ Cir. 230 § 10.36(a).

engages in a pattern or practice of failing to comply with the requirements for covered opinions,³⁰⁴ or

- take prompt action to correct noncompliance of a member, associate or firm employee whom the practitioner knows or has reason to know has engaged in a practice that does not comply with the requirements for covered opinions.³⁰⁵
 - In addition to the head(s) of a tax department, the regulations are silent as to whether the head of a firm's opinion committee, and/or a firm's managing partner could also constitute practitioners with oversight responsibility for the firm's tax practice (or not).
- The final regulations unfortunately impose liability on practitioners for actions of other practitioners under their supervision without providing any guidance as to what procedures will be considered sufficient. Hopefully such guidance will be issued either in the form of one or more safe harbors, or through examples of accepted procedures.

G. Effective Date

- The final Circular 230 regulations are applicable to written advice that is rendered after June 20, 2005.

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³⁰⁴ Cir. 230 § 10.36(a)(1).

³⁰⁵ Cir. 230 § 10.36(a)(2).