CIRCULAR 230 AND OTHER RECENT TAX SHELTER DEVELOPMENTS

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Tax Shelter Regulations

The tax shelter regulations include disclosure requirements for participants in "reportable transactions", and list-maintenance and disclosure requirements for "material advisors" with respect to reportable transactions. The first part of this article analyzes the new tax shelter system and the penalties for noncompliance. The balance of the article analyzes the new Circular 230 regulations.

Tax Shelter Participant Disclosure Requirements The regulations set forth the following six categories of reportable transactions:[1] (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.

Every taxpayer that is required to file a U.S. tax return that "participates" in a reportable transaction must: (i) mail Internal Revenue Service ("I.R.S.") Form 8886 to the IRS Office of Tax Shelter Analysis for the first year the taxpayer participates in the transaction, (ii) attach IRS Form 8886 to its tax return for each year in which the taxpayer participates in the transaction,[2] and (iii) retain a copy of all documents and other records related to the reportable transaction that are material to an understanding of the tax treatment and tax structure of the transaction until the statute of limitations runs.[3] However, taxpayers are not required to retain nonsubstantive emails and other documents that are not material to the tax treatment or tax structure of the transaction.

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1 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). 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).

2 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).

3 Treas. Reg. § 1.6011-4(a), (d).

The documents required to be retained by the taxpayer may include (i) marketing materials related to the transaction, (ii) written analyses used in transaction related decision-making, (iii) transaction

A taxpayer's failure to comply with the reportable transaction disclosure requirements may affect the taxpayer's ability to avoid penalties. For example, recently enacted regulations provide that 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.[4] Moreover, a taxpayer that has not adequately disclosed a reportable transaction in accordance with the tax shelter regulations may not rely on the adequate disclosure exception to the accuracy related penalty for disregard of rules and regulations.[5] Finally, the recently enacted regulations deny the "realistic possibility" defense for a taxpayer that disregards a revenue ruling or notice with respect to a reportable transaction.[6]

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 transaction (and any "substantially similar" transaction).[7] 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.[8] 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).[9] "Tax benefits"

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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). However, taxpayers are 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. Treas. Reg. § 1.6011-4(g).

4 Treas. Reg. § 1.6664-4(d).

5 Treas. Reg. § 1.6662-3(a).

6 Treas. Reg. § 1.6662-3(a).

7 Treas. Reg. § 1.6011-4(b)(2). If a transaction becomes a listed transaction 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 as an attachment to the taxpayer's first tax return filed after the date the transaction is listed, even if the taxpayer did not participate in the transaction in that year. Treas. Reg. § 1.6011-4(e)(2)(i).

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

9 Treas. Reg. § 1.6011-4(c)(3)(i).

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.[10]

Confidential Transactions Prior tax shelter 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 confidential transaction if the transaction documents contained a "tax confidentiality waiver."[11] In response to significant criticism regarding the breadth of the confidential category of reportable transactions,[12] the IRS and the Treasury Department issued new final regulations significantly narrowing the definition of a confidential transaction.[13] The preamble to the new regulations provides that a transaction will no longer be treated as a confidential reportable transaction solely by reason of confidentiality limitations imposed by a principal to a transaction acting as such.[14] Instead, a transaction will be 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."[15]

Although, the scope of the term "tax strategy" is unclear, 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). In addition, because the term "advisor" is not defined in the final regulations and may be interpreted quite broadly, many law firms and financial intermediaries continue to include tax confidentiality waivers in certain documents to ensure non-confidentiality. Presumably an advisor includes any attorney, accountant, investment banker, or other individual that is paid a fee for advice regarding a "tax strategy." It is not clear, however, whether an advisor includes a principal who discusses a tax strategy that affects deal pricing with other parties. It is also not clear whether some or all fees received by an advisor that also participates in the transaction as a principal may

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10 Treas. Reg. § 1.6011-4(c)(5).

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

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

13 For comments addressing the revisions to the confidentiality provisions, *see* NYSBA 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).

14 T.D. 9108, 68 Fed. Reg. 75128 (Dec. 30, 2003).

15 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 final regulations do not define the terms "tax strategies" or "tax advisor."

be considered received in that person's capacity as principal.[16] More specifically, questions remain as to whether a specific allocation of fees will be respected, and when a person with two roles will 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.[17] However, it is unclear what it means 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. Additional questions regarding the application of the confidential transaction category of the tax shelter regulations include what result obtains if an advisor imposes confidentiality on an opposing principal party, but not on its own client acting as a principal or 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 government argue that the transaction should be treated as confidential under the regulations?[18]

In the opinions of the authors, 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, cautious practitioners will recommend that such transactions also include confidentiality waivers.

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16 The regulations provide that:

> . . . [a]ll fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a transaction that is a potentially abusive tax shelter 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.

17 Treas. Reg. § 1.6011-4(b)(3)(ii).

18 Other limitations the IRS may consider evidence of a confidential transaction include confidentiality imposed by an advisor for only a limited period of time, *i.e.*, during initial negotiations, and perhaps limitations on opinion reliance (*e.g.*, only the addressee is permitted to rely).

Loss Transactions A loss transaction is defined as any transaction that results in a loss of at least: (i) $10 million in a single year or $20 million in any combination of years for corporations and partnerships (all of whose partners are corporations), (ii) $2 million in a single year or $4 million in any combination of years for all other taxpayers, or (iii) $50,000 in any single year for individuals or trusts that recognize a foreign currency loss.[19] A taxpayer participates in a loss transaction if the taxpayer's tax return reflects a loss equal to or greater than the applicable threshold,[20] taking into account only losses claimed in the first taxable year the transaction occurs and the five succeeding taxable years combined.[21] 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 return that reflects any amount of loss from the transaction.[22]

A safe harbor excepts from reportable transaction treatment transactions involving assets in which the taxpayer has "qualifying basis."[23] However, the safe harbor is not available if the asset is an interest in a "pass-through entity" other than a regular REMIC interest (*e.g.*,

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[19] Treas. Reg. § 1.6011-4(b)(5)(i)(A)-(D).

[20] Treas. Reg. § 1.6011-4(c)(3)(i)(D).

[21] Treas. Reg. § 1.6011-4(b)(5)(ii). In addition, in determining whether a transaction results in a loss in excess of 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 other disposition, or otherwise results in a deduction under section 165. Treas. Reg. § 1.6011-4(b)(5)(iii).

[22] Treas. Reg. § 1.6011-4(e)(2)(ii).

[23] Rev. Proc. 2004-66, 2004-50 I.R.B. 1 (Nov. 16, 2004). 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, 2004-50 I.R.B. 1 (Nov. 16, 2004).

partnerships, PFIC and FPHC equity interests, and REMIC residual interests).[24] Revenue Procedure 2004-66 also exempts certain other losses.[25]

Contractual Protection Transactions Contractual protection transactions include any transaction for which (i) 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, or (ii) the tax advisor's fees are contingent on the taxpayer's realization of the tax benefits from the transaction.[26] A taxpayer participates in a contractual protection transaction if the taxpayer's tax return reflects a tax benefit from the transaction and either the taxpayer has the right to a refund of fees paid or the taxpayer's obligation to pay fees is contingent.[27]

Transactions Giving Rise to a Significant Book-Tax Difference A transaction giving rise to a significant book-tax difference is 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 $10 million in any year, other than certain exempted transactions.[28] In determining whether a transaction has a significant book-tax difference in any taxable year, the taxpayer must first identify the transaction and then determine which items of income, gain, expense, or loss result from that transaction. If the book-tax difference for all of the items resulting from the transaction (determined without netting) exceeds $10 million in any taxable year, the transaction is a significant book-tax difference reportable transaction.[29] A taxpayer participates in a significant book-tax difference transaction if the taxpayer's tax treatment of an item differs from the book treatment of the item by an amount in excess of $10 million in any year (on a gross basis).[30]

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[24] 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. 2003-24, 2003-11 I.R.B. 1 (Feb. 27, 2003).

[25] *See* Rev. Proc. 2004-66, 2004-50 I.R.B. 1 (Nov. 16, 2004). Revenue Procedure 2004-66 modifies and supercedes Revenue Procedure 2003-24.

[26] Treas. Reg. § 1.6011-4(b)(4). 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.

[27] Treas. Reg. § 1.6011-4(c)(3)(i)(C).

[28] Treas. Reg. § 1.6011-4(b)(6)(i), (ii)(A).

[29] Revenue Procedure 2004-67 provides the following example: A taxpayer participates in one transaction in which book income exceeds taxable income by $3 million for an income item, tax expense exceeds book expense by $5 million for an expense item, and tax expense exceeds book expense by $4 million for a second expense item (none of which are excluded items). According to the Revenue Procedure, the transaction has a book-tax difference of $12 million and is a significant book-tax difference reportable transaction.

[30] Treas. Reg. § 1.6011-4(c)(3)(i)(E).

Revenue Procedure 2004-67 exempts the following book-tax difference items and transactions from the reportable transaction characterization:[31] (i) items resulting in a book loss or expense before or without a tax loss or deduction,[32] (ii) dividends, deemed dividends and income inclusions under the CFC, PFIC, and FPHC regimes, (iii) a dividends paid deduction by a publicly traded real estate investment trust, (iv) items resulting from tax-free contributions, reorganizations, mergers, acquisitions and spin-offs, (v) items resulting from like-kind exchanges under section 1031, (vi) transactions that are treated as a financing for tax purposes, but as a sale, purchase, or lease for book purposes (including transfers to a REMIC in exchange for a regular or residual REMIC interest), (vii) transactions that are subject to hedge or mark-to-market treatment for tax purposes, but not for book purposes (or vice versa), and (viii) items resulting from the use of different book and tax treatment of original issue discount, market discount, acquisition discount, de minimis original issue discount, qualified stated interest, amortizable bond premium, bond issuance premium, or debt issuance costs.

On July 7, 2004 the Treasury Department and the IRS released a draft of the final version of Schedule M-3, "*Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More,*" for use by corporate taxpayers with total assets of $10 million or more filing a U.S. corporate income tax return on Form 1120.[33] The new Schedule M-3 expands the current Schedule M-1, which reconciles a corporation's financial accounting income or loss with the taxable income or loss reported on Form 1120.

Concurrently with its release of the draft final version of Schedule M-3, the Treasury Department and the IRS issued Revenue Procedure 2004-45, which provides alternative disclosure procedures that will satisfy a taxpayer's tax shelter disclosure obligations for transactions with a significant book-tax difference.[34] Revenue Procedure 2004-45 generally provides that a corporation may satisfy its tax shelter disclosure requirements for a transaction with a significant book-tax difference by properly and timely completing and filing its Schedule

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[31] Rev. Proc. 2004-67, 2004-50 I.R.B. 1 (Nov. 16, 2004). Rev. Proc. 2004-67 modifies and supercedes Rev. Proc. 2003-35.

[32] By contrast, a taxpayer that reports an item of income for book purposes before reporting the item for tax purposes (as is generally the case for a taxpayer holding a market discount bond) will experience a book-tax difference.

[33] *See* IR-2004-91 (July 7, 2004). The Schedule M-3 is effective for use with federal income tax returns for tax years ending on or after December 31, 2004. A corporation is required to complete only Part I and Columns B and C of Parts II and III for the first taxable year in which it is required to file Schedule M-3. However, the corporation must complete Schedule M-3 in its entirety for all subsequent other taxable years for which it is required to file Schedule M-3.

Many taxpayers have expressed concern that they will not be able to comply with the effective date of the required disclosures. *See* Gray, "Treasury Official Gives Schedule M-3 States Update," 2004 TNT 100-3 (May 21, 2004). Although taxpayers have complained that the $10 million threshold is too low, the Treasury Department has indicated that it does not expect this threshold to be raised. *See* Gray, "Treasury Official Gives Schedule M-3 Status Update," 2004 TNT 100-3 (May 21, 2004).

[34] Rev. Proc. 2004-45, 2004-31 I.R.B. 1 (July 7, 2004). On August 6, 2004 the Treasury Department and the IRS issued interim guidance in a question and answer format regarding the alternative disclosure procedures described in Revenue Procedure 2004-45. *See* Treasury Release Providing Answers to Schedule M-3 Questions, JS-1848 (Aug. 6, 2004).

M-3, if it is otherwise required to do so. A taxpayer that is not required to file Schedule M-3 may satisfy its tax shelter disclosure requirements by disclosing on a Schedule M-3 each item of income, gain, loss, deduction, or credit for which the difference between the amount included in the taxpayer's financial statement net income (loss) for the taxable year and the amount included in taxable income for the taxable year is greater than $10 million as if it were a corporation required to complete and file the Schedule M-3 for the taxable year. The taxpayer must send a copy of the Schedule M-3 and any supporting statements to the Office of Tax Shelter Analysis on or before the due date for the taxpayer's timely filed original tax return (including extensions).

Brief Holding Period Tax Credit Transactions A tax credit transaction involving a brief holding period is 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).[35] It is not clear whether a transaction involving an asset held since inception, albeit for less than 45 days, would constitute a reportable transaction under this provision. A taxpayer participates in a brief asset holding period transaction if the taxpayer's tax return reflects a tax credit exceeding $250,000 from a brief asset holding period transaction.[36]

Revenue Procedure 2004-68 exempts 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,[37] (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,[38] 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)).[39]

Application of the Reportable Transaction 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

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[35] Treas. Reg. § 1.6011-4(b)(7). The principles of section 246(c)(3) and (c)(4) apply for purposes of determining an asset's holding period. Rev. Proc. 2004-68, 2004-50 I.R.B. 1 (Nov. 16, 2004).

[36] Treas. Reg. § 1.6011-4(c)(3)(i)(F).

[37] This exception applies 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.

[38] For purposes of this exception, the taxpayer's holding period in the debt instrument is 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.

[39] Rev. Proc. 2004-68, 2004-50 I.R.B. 1 (Nov. 16, 2004).

owns 10% of the voting stock in the CFC is treated as participating in a reportable transaction.[40] 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.[41]

Listing Requirements For Material Advisors Each "material advisor" is subject to tax shelter listing requirements. A material advisor includes 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 expects to receive at least a $50,000 fee ($10,000 for a listed transaction) for advising on or implementing a transaction, or a $250,000 fee ($25,000 for listed transactions) if every person to whom the material advisor makes a tax statement is a corporation.[42] A statement that includes only information contained in publicly available documents filed with the SEC by the close of a transaction will not be considered a tax statement for this purpose.[43] A person will be considered a material advisor with respect to a significant book-tax difference transaction 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.[44]

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, including taxpayer identification numbers and detailed transaction descriptions.[45] Multiple material advisors that are required to maintain lists may designate a single material advisor to maintain the list.[46] However, the designation of one material advisor to maintain a list does not relieve the other material advisors from their obligation to furnish the list to the IRS if the designated list keeper fails to do so.[47] 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.

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[40] 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.

[41] 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.

[42] Treas. Reg. § 301.6112-1(c)(2)(iii)(B).

[43] Treas. Reg. § 301.6112-1(c)(2)(iv)(B).

[44] Notice 2004-80, 2004-50 I.R.B. 1 (Nov. 16, 2004).

[45] Treas. Reg. § 301.6112-1(f).

[46] Treas. Reg. § 301.6112-1(h).

[47] Treas. Reg. § 301.6112-1(h).

Tax Shelter Disclosure Requirements For Material Advisors The JOBS Act replaces the tax shelter registration regime that existed under prior law with a requirement that "material advisors" file information returns with the IRS with respect to reportable transactions.[48] A ''material advisor'' for purposes of this requirement has the same definition as for purposes of the material advisor listing requirements.[49] A ''reportable transaction'' for purposes of this requirement has the same definition as for purposes of the participant disclosure requirements.[50] Each material advisor must timely file an information return with the IRS with respect to any reportable transaction for which the material advisor provided material aid, assistance or advice after October 22, 2004.[51] The return must include: (i) information identifying and describing the transaction, (ii) information describing any potential tax benefits expected to result from the transaction, and (iii) such other information as the IRS may prescribe.[52] The information return must be filed on IRS Form 8264 within 30 days after the date on which a person becomes a material advisor.[53] 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

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

49 Notice 2004-80, 2004-50 I.R.B. 1 (Nov. 16, 2004). The material advisor listing requirements define a material advisor as 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, <u>and</u> expects to receive at least a $50,000 fee ($10,000 for a listed transaction) for advising on or implementing a transaction, or a $250,000 fee ($25,000 for listed transactions) if every person to whom the material advisor makes a tax statement is a corporation.

New section 6111(c) permits the IRS to prescribe regulations that (i) require only one material advisor has 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 (e.g., rules for aggregating fees in appropriate circumstances).

50 I.R.C. § 6111(b)(1) as amended by the JOBS Act; Notice 2004-80, 2004-50 I.R.B. 1 (Nov. 16, 2004). For purposes of new section 6111(a) a "reportable transaction" is defined in Treasury regulations section 1.6011-4(b), which define reportable transactions as (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.

The rules in Treasury regulations section 301.6112-1(b)(2) and (c)(2) (without regard to provisions relating to registered transactions under former section 6111) apply to determine whether a transaction is a reportable transaction with respect to a material advisor).

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

52 I.R.C. § 6111(c) as amended by the JOBS Act. It is expected that 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.

53 Notice 2004-80, 2004-50 I.R.B. 1 (Nov. 16, 2004). A person who becomes a material advisor between October 23, 2004 and December 31, 2004, must file the required information return before February 1, 2005. Prior registration under the old registration regime generally satisfies the information return filing requirement.

effective for taxable years with respect to which the period for assessing a deficiency did not expire before October 22, 2004.[54]

Tax Shelter Penalty Regime

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 this 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).[55] 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.[56] The penalty applies regardless of whether the taxpayer's position is sustained on the merits[57] and may be imposed in addition to any accuracy related penalties.[58]

The IRS has indicated in interim guidance that it will impose a penalty with respect to <u>each</u> failure to (i) attach a reportable transaction disclosure 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.[59] However, a taxpayer that fails to attach the disclosure statement to an original or amended return <u>and</u> 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.[60]

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.[61] 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

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54 Act Sec. 814 of the JOBS Act, adding I.R.C. § 6501(c)(10).

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

56 Notice 2005-11, I.R.B. 2005-7 (Feb. 14, 2005).

57 H.R. Rep. No. 108-548, pt 1.

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

59 I.R.S. Notice 2005-11, I.R.B. 2005-7 (Feb. 14, 2005).

60 Notice 2005-11, I.R.B. 2005-7 (Feb. 14, 2005).

61 I.R.C. § 6707A(d) as added by the JOBS Act. The authority to rescind the penalty is exercisable only 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.

of fact, and (iii) imposing the penalty would be against equity and good conscience.[62] The IRS may not rescind the penalty with respect to a listed transaction.[63] 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.[64] Failure to disclose the penalty in an SEC report as required is treated as a failure to disclose a listed transaction.[65]

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.[66] 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 request by the IRS within 20 business days after the request will be subject to a $10,000 per day penalty.[67] The IRS may waive the penalty if the failure to make the list available is due to reasonable cause.[68] However, the failure to maintain a list does not constitute reasonable cause.[69] 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.

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 (i) $50,000 with respect to a reportable transaction that is not a listed transaction, or (ii) with respect to a listed transaction, the greater of (x) $200,000 or (y) 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).[70] 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.[71] In determining whether to rescind the penalty the IRS may take

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62 H.R. Conf. No. 108-755.

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

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

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

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

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

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

69 H.R. Rep. No. 108-548.

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

71 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.

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.[72] The penalty applies to tax returns due after October 22, 2004.[73]

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 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").[74] 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.[75] The JOBS Act increased the penalty for false tax benefit statements with respect to activities occurring after the 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.[76]

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.[77] 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 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.[78]

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.[79] 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,

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

73 Act. Sec. 816(c) of the JOBS Act.

74 I.R.C. § 6700(a).

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

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

77 I.R.C. § 7408.

78 I.R.C. § 7408(c), as amended by the Jobs Act.

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

2004 between all taxpayers (including non-corporate taxpayers) and the taxpayer's federally authorized tax practitioner.[80]

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)). 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.[81]

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.[82] Effective for taxable years ending after October 22, 2004, the JOBS Act modifies the accuracy-related penalty provisions applicable to tax shelters by replacing the existing rules with a new accuracy-related penalty regime under new section 6662A that applies to reportable transactions.[83] The accuracy-related penalty provisions in new section 6662A apply to reportable transactions as defined in Treasury regulation section 1.6011-4.[84]

In general, 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 <u>failed to adequately disclose</u> in accordance with the participant reportable transaction disclosure requirements. There are no exceptions to this penalty. Alternatively, a lesser 20% accuracy-related penalty is imposed on any understatement attributable to an <u>adequately disclosed</u> 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 (i) have adequately disclosed the relevant facts affecting the tax treatment of the transaction under section 6011,[85] (ii) demonstrate that

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

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

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

83 I.R.C. § 6662(d)(2)(C). 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.

84 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).

85 A taxpayer has adequately disclosed the facts if it has either filed a disclosure statement in the form and manner prescribed by Treasury regulation section 1.6011-4(d) or has been deemed to satisfy its

there was substantial authority for the claimed tax treatment of the transaction, and (iii) demonstrate that it reasonably believed that the claimed tax treatment was more likely than not the proper treatment.[86] A taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (i) is based on the facts and law that exist at the time the tax return including the item was filed, and (ii) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (x) a return will not be audited, (y) the treatment will not be raised on audit, or (z) the treatment will be resolved through settlement if raised.

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 (i) is provided by a ''disqualified tax advisor'', (ii) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (iii) unreasonably relies upon representations, statements, finding or agreements of the taxpayer or any other person, (iv) does not identify and consider all relevant facts, or (v) fails to meet any other requirement prescribed by the IRS. A disqualified tax advisor is any advisor who (i) is a material advisor and who participates in the organization,[87] management,[88] promotion[89] or sale of the transaction or is

disclosure obligations under Revenue Procedure 2005-45 or any other published guidance. Notice 2005-12, I.R.B. 2005-7 (Feb. 14, 2005).

86 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. 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.

87 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 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 (ii) registering the transaction with any federal, state or local government body. Notice 2005-12, I.R.B. 2005-7 (Feb. 14, 2005).

88 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, I.R.B. 2005-7 (Feb. 14, 2005).

89 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, I.R.B. 2005-7 (Feb. 14, 2005). Thus, an advisor who

related to any person who so participates,[90] (ii) is compensated directly or indirectly by a material advisor with respect to the transaction under a referral fee or fee sharing arrangement a "disqualified compensation arrangement",[91] (iii) 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 (x) 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 (y) the amount of the fee is contingent on the taxpayer's realization of tax benefits from the transaction, or (iv) as determined under regulations, has a disqualifying financial interest with respect to the transaction. Any 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.

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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.

90 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, I.R.B. 2005-7 (Feb. 14, 2005). 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, I.R.B. 2005-7 (Feb. 14, 2005).

91 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, I.R.B. 2005-7 (Feb. 14, 2005).

Final Circular 230 Regulations

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 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 efforts culminated with its publication of the final Circular 230 regulations. The final Circular 230 regulations have the following three purposes, (i) establish "best practices" for "tax advisors" providing tax advice, (ii) set forth the requirements for practitioners providing "covered" opinions and other written advice, and (iii) provide compliance procedures for persons with responsibility for overseeing a firm's tax practice.

Scope of Circular 230 and Penalties for Non-Compliance A threshold question is whether Circular 230's regulation of written tax advice exceeds its authority to "regulate the practice of representatives of persons before the Department of the Treasury,"[92] "Practice" before the IRS includes all matters connected with a <u>presentation to the IRS</u> relating to a taxpayer's rights, privileges, or limitations under laws or regulations administered by the IRS.[93] 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 <u>the party or parties</u> on whose behalf he or she acts.[94] This person is a "practitioner" for purposes of the Circular 230 regulations.[95] Prior to the enactment of the JOBS Act many practitioners questioned (and still question) whether a tax attorney or an accountant who has not filed a written declaration with the IRS is a practitioner under Circular 230[96] and whether the Circular 230 regulations apply to an attorney or an accountant who will never appear before the IRS.

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. 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. In addition, the JOBS Act permits the IRS to impose monetary penalties on a tax practitioner's employer, firm, or other entity that knew, or

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[92] 31 U.S.C. § 330(a)(1).

[93] 31 C.F.R. § 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.

[94] 31 C.F.R. § 10.3(a).

[95] 31 C.F.R. § 10.2(e). The attorney may not currently be under suspension or disbarment from practice before the IRS.

[96] 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 Tax Notes 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* Stratton, "Opinion Standards to be Finalized Soon, Treasury Official Says," 2004 TNT 61-4 (Mar. 29, 2004).

reasonably should have known, of the practitioner's conduct. 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 censure of the practitioner.[97] The expanded sanctions included in the JOBS Act may be imposed on actions taken after October 22, 2004.

Recommended Best Practices for Tax Advisors The final Circular 230 regulations provide that "tax advisors"[98] 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:[99] (i) 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),[100] (ii) establish the relevant facts and evaluate the reasonableness of assumptions or representations,[101] (iii) 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,[102] (iv) advise clients regarding the importance of the conclusions reached (*e.g.*, whether taxpayer can avoid substantial understatement penalties if it relies on the advice),[103] and (v) act fairly and with integrity in practice before the IRS.[104] 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.

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 the text to be set forth in a separate section at the beginning of the written advice in bolded typeface that is larger than any other typeface used in the written advice.[105]

Description of Covered Opinions A covered opinion is written advice (including email) by a practitioner concerning a federal tax issue that arises from (i) a listed transaction, (ii) 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 (iii) any plan or arrangement, a significant purpose of which is the avoidance or evasion of tax imposed by the Code (a

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97 *See* Act Sec. 882(a)(1) of the Jobs Act, amending 31 U.S.C. § 330(b); Act Sec. 822(b), adding 31 U.S.C. § 330(d); Act Sec. 882(a)(2).

98 The final Circular 230 regulations do not define the term "tax advisor."

99 Cir. 230 § 10.33(b).

100 Cir. 230 § 10.33(a)(1).

101 Cir. 230 § 10.33(a)(2).

102 Cir. 230 § 10.33(a)(2).

103 Cir. 230 § 10.33(a)(3).

104 Cir. 230 § 10.33(a)(4).

105 Cir. 230 § 10.35(b)(8).

"significant purpose tax avoidance transaction"), if the written advice is a reliance opinion or a marketed opinion, or is subject to conditions of confidentiality, or contractual protection.[106] 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-transfer of property, or the value of property for federal tax purposes.[107]

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 "more likely than not."[108] 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.[109] 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[110] the accuracy-related penalty regulations define reasonable 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."[111] 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.[112]

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[106] Cir. 230 § 10.35(b)(2).

[107] Cir. 230 § 10.35(b)(3).

[108] Cir. 230 § 10.35(b)(4).

[109] Cir. 230 § 10.35(b)(3).

[110] *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 Tax Notes 1209, (Dec. 9, 1996) (reasonable basis is generally a 15-20% likelihood of success).

[111] 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).

[112] 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.

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.[113] The Circular 230 regulations do 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) constitute principal purpose tax avoidance transactions. 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.

Requirements for Covered Opinions A covered opinion must identify and consider all relevant facts.[114] 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.[115] The opinion must identify in a separate section all factual representations, statements or findings of the taxpayer that the practitioner is relying upon. The opinion may not assume a business purpose or a potential profit apart from tax benefits.[116] 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.[117] 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 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.[118]

A covered opinion must also relate the law (including potentially applicable judicial doctrines) to the relevant facts.[119] 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

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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).

[113] Cir. 230 § 10.35(b)(5).

[114] Cir. 230 § 10.35(c)(1).

[115] Cir. 230 § 10.35(c)(1)(ii) and (iii).

[116] Cir. 230 § 10.35(c)(1)(ii).

[117] Cir. 230 § 10.35(c)(1)(ii).

[118] Cir. 230 § 10.35(c)(1)(ii).

[119] Cir. 230 § 10.35(c)(2)(i).

opinion is limited or the practitioner properly relies on another legal opinion) or otherwise be based on unreasonable legal assumptions, representations or conclusions.[120] 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 respect to a limited scope opinion on a single issue, or transaction?

Morever, a covered opinion may not include internally inconsistent legal analyses or conclusions.[121] 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),[122] provide a conclusion as to the likelihood of success on the merits with respect to each <u>significant federal tax issue considered</u>, and describe the reasons for each conclusion (including the facts and analysis supporting each conclusion).[123] 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.[124] 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.[125] 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.[126] As discussed below, if a practitioner is unable to reach a conclusion with respect to any significant federal tax issue, the opinion cannot constitute a covered marketed opinion.

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 or the practitioner's firm) and any promoter, other than the client for whom the opinion was prepared.[127] 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 (i) 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 (ii) 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.[128] 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: (i) its scope is limited to the federal tax issues addressed in the opinion, (ii) additional issues may exist that could affect the federal tax treatment of the

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[120] Cir. 230 § 10.35(c)(2)(ii).

[121] Cir. 230 § 10.35(c)(2)(iii).

[122] Cir. 230 § 10.35(c)(3)(ii).

[123] Cir. 230 § 10.35(c)(3)(ii).

[124] Cir. 230 § 10.35(c)(iii).

[125] Cir. 230 § 10.35(c)(4).

[126] Cir. 230 § 10.35(c)(4).

[127] Cir. 230 § 10.35(e)(1).

[128] Cir. 230 § 10.35(e)(4).

transaction and the opinion does not consider or provide a conclusion with respect to any additional issues, and (iii) 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.[129]

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),[130] and prominently disclose that: (i) the opinion was written to support the marketing of the transaction, and (ii) the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.[131] 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."

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. A practitioner may not opt out of the covered opinion rules if the written advice pertains to a (i) listed transaction, (ii) principal purpose tax avoidance transaction, (iii) confidential transaction, or (iv) contractual protection transaction. A practitioner may opt out of the covered opinion requirements only if: (i) the opinion is either a reliance opinion or a marketed opinion, (ii) 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 (iii) if the opinion is a marketed opinion, it also prominently discloses that the advice was written to support the marketing of the arrangement, and the taxpayer should seek advice from its own independent tax advisor (*i.e.*, it contains the same disclosure required for covered marketed opinions).[132] 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, and 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.[133] 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).[134]

Requirements for Other Written Advice Concerning Federal Tax Issues (*i.e.*, Non-Covered Opinions) A practitioner must not provide written advice that (i) is based on unreasonable factual or legal assumptions, (ii) unreasonably relies on representations, statements, findings or agreements, (iii) give written advice that does not consider all relevant facts that the practitioner knows or should know, or (iv) considers or relies on the possibility that a tax return

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[129] Cir. 230 § 10.35(e)(3).

[130] Cir. 230 § 10.35(c)(4)(ii).

[131] Cir. 230 § 10.35(e)(2).

[132] Cir. 230 § 10.35(b)(4)(ii) and (5)(ii).

[133] Cir. 230 § 10.35(b)(2)(ii).

[134] Cir. 230 § 10.35(f)(2).

will not be audited, that an issue will not be raised on audit, or that an issue will be settled.[135] 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. 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.[136] 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.[137]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.

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[138] (i) 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 engages in a pattern or practice of failing to comply with the requirements for covered opinions,[139] or (ii) 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.[140] 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.

Effective Date The final Circular 230 regulations are effective as of June 20, 2005.

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135 Cir. 230 § 10.37(a).

136 Cir. 230 § 10.37(a)

137 Cir. 230 § 10.37(a).

138 Cir. 230 § 10.36(a).

139 Cir. 230 § 10.36(a)(1).

140 Cir. 230 § 10.36(a)(2).