Clients&FriendsMemo

Proposed Regulations Relax the Circular 230 Rules for Tax Practitioners

October 4, 2012

I. Introduction

On September 17, 2012, the Department of Treasury ("**Treasury**") and the Internal Revenue Service ("**IRS**") proposed regulations that would significantly relax Circular 230, which governs the conduct of tax practitioners and accountants.[1] The proposed changes, if finalized as proposed, would:

- eliminate the complex rules governing "covered opinions" and apply a single standard that applies to all written advice by tax practitioners,
- eliminate the need to include boilerplate "Circular 230" disclaimers on emails and other written advice,
- require law and accounting firms to employ procedures to ensure that practitioners comply with all requirements of Circular 230, and
- expand the categories of violations that subject practitioners to expedited suspension proceedings.[2]

The proposed changes are generally proposed to be effective when the final rules are published in the Federal Register.

Part II of this memorandum briefly summarizes the "covered opinion" rules in current Circular 230 and Treasury's reasons for proposing their elimination. Part III explains the proposed unified rules for all written advice. Part IV explains the new proposals to ensure law firm compliance with all of Circular 230. Part V explains other changes contained in the proposed regulations, and Part VI discusses the proposed effective dates.

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[1] The full name of Circular 230 is Treasury Department No. 230. It is contained in 31 Code of Federal Regulations Part 10.

[2] The proposed regulations also clarify that a practitioner may not endorse or negotiate an electronic payment of funds to a taxpayer by the IRS, and provide that a practitioner's willful pattern of failure to make his or her own required tax filings may subject the practitioner to expedited suspension proceedings.

II. The Covered Opinion Rules

Circular 230 currently provides strict standards for covered opinions. A covered opinion is written advice, including emails, concerning one or more federal tax issues relating to:

- a "tax avoidance transaction" listed by the IRS (a "listed transaction"),[3]
- any plan or arrangement (including any entity or investment plan) whose principal purpose is the avoidance or evasion of any tax imposed by the Internal Revenue Code,[4] or
- any plan or arrangement (including any entity or investment plan) that has a significant purpose of tax avoidance, if the written advice is intended to avoid penalties (a "reliance opinion"), is intended to promote, market or recommend an entity, plan or arrangement (a "marketed opinion"), or is subject to conditions of confidentiality, or if the practitioner's fees are contingent on the tax consequences from the plan or arrangement.[5]

Under the current rules, a covered opinion must:

- identify and consider all facts that the practitioner determines to be relevant,
- identify in a separate section all factual assumptions relied upon by the practitioner,
- identify in a separate section all factual representations, statements or findings of the taxpayer relied upon by the practitioner,
- relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts,
- consider all significant federal tax issues,[6]

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[3] Treasury regulations section 1.6011-4(b)(2). Currently there are 34 listed transactions.

[4] Under Circular 230, the principal purpose of a transaction is the purpose that exceeds in importance any other purpose. Tax avoidance can be the principal purpose even if all other purposes combined are greater in importance than the tax avoidance purpose, provided no other purpose is greater in importance than the tax avoidance purpose. However, the principal purpose of a transaction is not tax avoidance if the purpose is to claim tax benefits in a manner consistent with the Internal Revenue Code of 1986, as amended (the "Code") and Congressional intent.

[5] Under current Circular 230, claiming tax benefits authorized by the Code can be a significant tax avoidance purpose.

[6] There are two exceptions to the requirement of comprehensive legal analysis in current Circular 230. First, the practitioner and the taxpayer can agree that the practitioner will give a "limited scope" opinion which covers less than all of the significant issues, in which case the opinion can offer penalty protection only on the issues covered. Limited scope opinions are not permitted if the transaction is a listed transaction or has as its principal purpose tax avoidance or evasion, or if the opinion is a marketed opinion. The limited scope opinion under the current rules must include a section that identifies all the

- provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail on the merits with regard to each significant federal tax issue discussed and describe the reasons for the conclusions, including facts and legal analysis,[7] and
- provide the practitioner's overall conclusion as to the likelihood that the federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion, unless the practitioner cannot reach an overall conclusion, in which case the opinion must explain the practitioner's reason for not reaching an overall conclusion.[8]

As mentioned above, Treasury and the IRS have proposed to eliminate the covered opinion rules and replace them with a simpler unified standard for all written advice. The Preamble to the proposed regulations offers five main reasons for the proposed repeal. First, covered opinions are almost always more expensive and the benefit is insufficient to justify the additional cost. Second, the mechanical covered opinion requirements lead to unnecessary and highly technical discussions that may hinder the provision of efficient and quality tax advice. Third, there is no direct evidence that the covered opinion rules have been effective at curtailing abuses. Fourth, the increased costs and burdens of complying with the covered opinion rules may discourage taxpayers from obtaining written advice. Fifth, the Circular 230 disclaimers that practitioners include in their written advice to ensure that the covered opinion requirements will not apply may confuse clients and cause them to ignore the disclaimers altogether.

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issues for which the practitioner assumed a favorable outcome. The opinion must also prominently disclose that it is a limited scope opinion. Second, under certain conditions the practitioner may rely on the opinion of another practitioner regarding one or more significant tax issues.

In addition, written advice is generally not treated as a "reliance opinion" or "marketed opinion" if (i) the advice does not concern a listed transaction or a transaction that has its principal purpose tax avoidance or evasion, and (ii) the practitioner prominently discloses that the advice was not intended or written by the practitioner to be used (and that it cannot be used) by the taxpayer to avoid penalties that may be imposed and, in the case of a marketed opinion, that the advice was written to support the promotion or marketing of the transactions or matter addressed by it and that the taxpayer should seek advice based on his or her particular circumstances from an independent tax advisor. Practitioners commonly rely on this exception to ensure that an opinion is not treated as a reliance opinion or marketed opinion for purposes of the Circular 230 regime.

[7] If the practitioner cannot reach a conclusion on an issue at least at a confidence level of "more likely than not," the opinion must prominently disclose this fact, and state that the opinion with respect to this issue cannot be relied upon for the avoidance of penalties. However, a marketed opinion cannot be given at all unless the practitioner's confidence level is at least "more likely than not." Furthermore, the practitioner must list in the covered opinion the issue or issues for which he or she could not reach a conclusion.

[8] Under certain circumstances, practitioners may exclude advice from the covered opinion rules by making prominent disclosure that the advice was not intended or written to be used and cannot be used to avoid penalties. The Preamble indicates that this exemption has led to the "unrestrained use" of the disclaimer in written advice (including emails) in an attempt to remove the advice from the covered opinion requirements.

III. The Proposed Standards for All Written Advice

The proposed regulations replace current section 10.35 (which addresses covered opinions) with a new section 10.35 (which discusses the general requirements for practitioner competence), and replace current section 10.37 (which discusses the standards for written advice other than covered opinions) with a new section 10.37 (which provides a single standard of practice for all written advice).

Proposed section 10.35 provides that a practitioner must exercise competence when engaged in practice before the IRS and specifically states that competent practice requires "the knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged." The Preamble points out that no provision of current Circular 230 has this explicit requirement.

Proposed section 10.37 provides unified rules for all written advice (including emails) concerning one or more federal tax matters. The proposed standard is cast as both a set of affirmative general requirements and prohibitions. The practitioner must:

- base the written advice on reasonable factual and legal assumptions (including assumptions as to future events),
- reasonably consider all relevant facts that the practitioner knows or should know, and
- use reasonable efforts to identify and ascertain the facts relevant to each federal tax matter.

The practitioner must not:

- unreasonably rely upon representations, statements, findings or agreements (including projections, financial forecasts or appraisals) of the taxpayer or any other person, or
- take into account in evaluating a tax matter the possibility that a return will not be audited or, if audited, that an issue will not be raised by the IRS on audit.[9] (However, the proposed regulations, unlike current section 10.37, permit a practitioner to take into account in his or her advice the possibility that an issue will be resolved through settlement.)[10]

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[9] These prohibitions are also in current section 10.37.

[10] The Preamble states that Treasury and the IRS have concluded that the current rule that forbids a practitioner to take into account the possibility of settlement "may unduly restrict the ability of a practitioner to provide comprehensive written advice because the existence or nonexistence of legitimate hazards that may make settlement more or less likely may be a material issue for which the practitioner has an obligation to inform the client."

Proposed section 10.37 permits a practitioner in written advice to rely on the advice of another practitioner if that advice was reasonable and the reliance is in good faith considering all the facts and circumstances. The proposed regulations state that reliance is not reasonable when the practitioner (i) knows or should know that the opinion of the other practitioner should not be relied on, (ii) knows or should know that the other practitioner is not competent or lacks the necessary qualifications to provide the advice, or (iii) knows or should know that the other practitioner has a conflict of interest.[11]

Importantly, proposed section 10.37 does not require that the written advice include statements of relevant facts, assumptions or representations, the application of the law to the facts, or the practitioner's conclusion with respect to the law and the facts. Rather, the Preamble provides that the scope of the engagement, the specificity of the advice sought, and other appropriate facts and circumstances will determine the extent that these matters must be included in the written advice.

Current section 10.37 requires the IRS to consider all the facts and circumstances, including the scope of the engagement and the type and specificity of advice sought by the client, in evaluating whether written advice complies with the requirements of the section. Proposed section 10.37 explicitly requires that the IRS apply a reasonableness standard to the review. However, proposed section 10.37 maintains the current "heightened standard of review" in the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner in promoting, marketing, or recommending to one or more taxpayers an entity, plan or arrangement a significant purpose of which is the avoidance or evasion of any tax contained in the Code.[12] Neither the current nor proposed section 10.37 explains the difference between the reasonableness standard and the heightened standard of review.

IV. Procedures to Ensure Compliance With Circular 230

Current section 10.36 provides rules intended to ensure practitioner compliance only with the covered opinion rules and the requirements for preparing tax returns, claims for refund, or other documents for submission to the IRS. The proposed regulations amend section 10.36 to require that practitioners establish procedures to ensure their firms' compliance not only with the

[11] Under section 10.29 of the current regulations, a conflict of interest exists if the representation of one client will be directly adverse to another client or if there is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client or a former client. Notwithstanding any such conflict of interest, a practitioner may represent a client if the practitioner reasonably believes that he or she will be able to apply competent and diligent representation to each client, the representation is not prohibited by law, and each affected client waives the conflict and gives informed written consent to the representation.

[12] Current section 10.37 uses the phrase heightened standard of "care" rather than "review."

requirements for preparing returns and other documents, but with the requirements of Circular 230 generally.[13]

Current section 10.36 subjects practitioners who have or share principal authority for overseeing a firm's practice of providing written federal tax advice or preparing federal tax returns to discipline for failing to comply with this requirement if (i) through willfulness, recklessness or gross incompetence they do not take reasonable steps to ensure compliance and one or more members, associates or employees of the firm are engaged in, or have engaged in, a pattern or practice (in connection with their practice with the firm) of failing to comply,[14] or (ii) they know or should know that one or more members, associates or employees are engaged in, or have engaged in, a pattern or practice of noncompliance, and they, through willfulness, recklessness or gross incompetence fail to take prompt action to correct the noncompliance.[15] Under the current rules, supervising practitioners must ensure that practitioners who provide written advice comply with the covered opinion rules and practitioners who prepare returns and other IRS submissions comply with Circular 230 generally. The proposed rules require supervisors to ensure (using the same standards) that all practitioners comply with all of Circular 230.

V. Other Proposed Changes

1. Endorsing or Negotiating Taxpayer Refunds

Current section 10.31 provides that a practitioner must not endorse or otherwise negotiate any check issued by the United States to a taxpayer in respect of a federal tax liability. The proposed regulations clarify that this prohibition prevents the practitioner from directing or accepting payment of the refund by any means, electronic or otherwise, in an account owned or controlled by the practitioner or any firm or other entity with which the practitioner is associated. The proposed regulations also broaden the coverage of the section to apply to all practitioners, and not only not practitioners who prepare tax returns.[16]

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[13] Proposed section 10.36 no longer addresses compliance with the covered opinion rules because the proposed regulations contemplate the repeal of the covered opinion rules.

[14] The proposed regulations do not define a pattern or practice, but it would appear from the choice of words that one such failing by a member, associate or employee is insufficient to trigger discipline against the practitioner with principal authority.

[15] The proposed regulations do not define "prompt action."

[16] Current section 10.31 is limited to practitioners who prepare tax returns.

2. Expedited Suspension Proceedings

Current section 10.82 of Circular 230 contains rules for the expedited suspension of practitioners who engage in certain conduct.[17] If the practitioner engages in any such conduct, he or she may be suspended immediately following the expiration of the period in which his answer to the complaint must be filed, or, if the taxpayer requests a conference, immediately following that conference.

The proposed regulations broaden the prohibited conduct to include the willful failure to comply with the practitioner's own federal tax filing obligations. Proposed section 10.82 permits expedited suspension of a practitioner who fails to make his or her required annual federal tax return during four of the five tax years immediately preceding the commencement of a proceeding for expedited suspension, and remains noncompliant with any of the practitioner's federal tax filing obligations at the time the notice of suspension is issued, or (ii) fails to make a return that is required to be filed on more than an annual basis during five of the seven periods immediately preceding the commencement of a proceeding and remains noncompliant with any of the practitioner's federal tax filing obligations at the time the notice of suspension is issued.[18]

The current rules for expedited suspensions do not specifically allow a suspended practitioner to apply for reinstatement or indicate when he or she may apply for reinstatement, but current section 10.81 permits disbarred practitioners to apply for reinstatement after five years following disbarment. Proposed section 10.81 applies the five-year time period to both disbarments under current section 10.60 and expedited suspensions under section 10.82.

The Preamble clarifies that a practitioner subject to expedited proceedings may request a formal complaint under section 10.60, which would bring the suspension before an administrative law judge. Proposed section 10.82(g) allows any practitioner who has been suspended under an expedited proceeding to demand in writing that the IRS institute a proceeding under section 10.60 and issue a formal complaint. The demand must be made within two years from the date the

[17] The conduct includes (i) the suspension or revocation for cause of the practitioner's license to practice, (ii) conviction of any crime under the Code, any crime involving dishonesty or breach of trust, or any felony for which the conduct renders the practitioner unfit to practice before the IRS, (iii) violations of conditions imposed pursuant to a prior suspension, disbarment or censure, or (iv) sanction by a court of competent jurisdiction with respect to a taxpayer's or the practitioner's tax liability for instituting or maintaining proceedings primarily for delay, advancing groundless or frivolous arguments or failing to pursue available administrative remedies. The conduct includes any of these offenses committed within 5 years of the date the IRS commences a proceeding for expedited sanction.

[18] A practitioner who is accused of failure to file the requisite number of periodic returns cannot avoid immediate suspension if he or she is derelict in any annual filings at the time the notice of suspension is issued. The same holds true for a taxpayer who is accused of failure to file annual returns if at the time the notice of suspension is issued, he or she is derelict in any periodic filings.

practitioner's suspension began. The IRS must issue the complaint within 45 days of receiving the demand.[19]

3. Municipal Bond Opinions

The proposed regulations withdraw earlier proposed regulations governing requirements for state or local bond opinions. The earlier proposals are no longer necessary because of the proposed elimination of the covered opinion rules. Practitioners rendering opinions concerning the tax treatment of municipal bonds would be subject to the same professional standards that apply to all written tax advice under proposed section 10.37.

4. Scope of the IRS Office of Professional Responsibility

Current section 10.1 states that the IRS's Office of Professional Responsibility "generally" has responsibility for matters relating to practitioner conduct and discipline, including disciplinary proceedings and sanctions. Proposed section 10.1 clarifies that the Office of Professional Responsibility has "exclusive responsibility for discipline, including disciplinary proceedings and sanctions" related to practice before the IRS.

VI. Effective Dates

The proposed regulations generally apply on the date that final regulations are published in the Federal Register.

Any proceedings instituted under Circular 230 prior to the date that final regulations are published in the Federal Register will not be affected by these revisions.

The proposals also provide that if a proceeding is instituted after the effective date, and the proceeding concerns practitioner conduct that occurred before the effective date, the conduct will be judged by the rules in effect when the conduct occurred.

Until these revisions become effective, current Circular 230, including the rules on covered opinions, will continue to apply.

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[19] It appears from the language of the proposed regulations that the practitioner cannot demand a complaint after the expedited proceedings were commenced but before he or she was actually suspended under those proceedings.

Please feel free to contact any Cadwalader attorney listed below if you have any questions about this memorandum.

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