Circular 230: An Overview

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Dennis Brager, Charles Cobb, Kip Dellinger and William Quealy review the new written advice and best practice standards of Circular 230 and look at Circular 230 more generally to review some of the practice standards on which the IRS Office of Professional Responsibility appears to have focused.

The written advice and best practice standards added to the Circular 230 regulations have generated considerable comment since they were first proposed at the end of 2003. In the meantime, the Office of Professional Responsibility (OPR) has virtually doubled in size during 2004 and 2005, and OPR management has indicated that the Office intends to increase enforcement through disciplinary actions against practitioners subject to Circular 230[1] in other areas of required compliance under the Circular. The purpose of this article is two-fold. The first is to review the new written advice and best practice standards. The second is to look at Circular 230 more generally and review some of the practice standards on which the OPR appears to have focused.

American Jobs Creation Act of 2004 Provisions for Standards of Practice and Professional Conduct[2]

Secretary of the Treasury Authorized to Regulate Opinions

When the IRS proposed in December 2003, to revise Circular 230 to include detailed requirements to be followed (and language to be included) in "tax shelter opinions," several commentators in the legal profession questioned whether the IRS possessed the authority to dictate to tax professionals how to write tax opinions.

The IRS responded by seeking and securing enabling legislation (in the form of "clarification" of its right) to regulate written tax advice "with respect to any entity, transaction, plan or arrangement, or other plan or arrangement, which is of a type which the Secretary [of the Treasury] determines as *having a potential for tax avoidance or evasion"* (italics supplied).

> **Observation.** This provision is a very broad, all-encompassing grant of authority permitting the IRS to dictate professional standards to attorneys and CPAs.

Imposition of Sanctions and Monetary Penalties Against Persons Authorized to Practice

In addition to suspension or disbarment for violations of the Circular 230 standards regulating the conduct of CPAs, attorneys, enrolled agents and enrolled actuaries in their representation of taxpayers before IRS, the American Jobs Creation Act of 2004(AJCA)[3] empowers the government to (a) censure those persons and (b) to impose monetary penalties.

The monetary penalty is in addition to other disciplinary action and may equal the gross income derived from the conduct giving rise to the penalty.

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Employer/Supervisor Penalties

Moreover, a monetary penalty may also be assessed against an employer if the employer, firm or entity knew, or *reasonably should have known*, of the conduct.

Circular 230 Best Practice, Tax Shelter Opinions and Other Written Advice Standards[4]

Background

In December 2003, the Treasury issued proposed changes to the Circular 230 regulations (which govern the conduct of those who represent taxpayers before the IRS) that provided for the establishment of "best practices" by representatives and their firms, or employer, and provided specific requirements and standards for the issuance of "tax shelter opinions."

Not surprisingly, there was a great outcry among tax professionals (and attorneys, in particular) about overreach on the part of the IRS and the possibility that tax advisor/client relationships would be seriously, adversely impacted. An enormous volume of commentary was received at the IRS with respect to the proposals.

So, in December 2004, the Treasury revised the Circular 230 changes and issued "final" regulations that took effect June 20, 2005 (180 days after their December release).

Again, not surprisingly, there was perhaps an even greater outcry among tax professionals (and attorneys, in particular) about overreach on the part of the IRS and the possibility that tax advisor/client relationships would be seriously, adversely impacted. An enormous volume of commentary was received at the IRS with respect to the proposals and is still pouring in.

The Treasury responded by making certain additions and revisions to the proposals and, despite requests from countless tax professionals and organizations to delay the effective date of the new standards, the Circular 230 provisions went into effect as scheduled.

Far-Reaching Effect on Lawyers and CPAs

Circular 230 governs written communications concerning any federal tax of every attorney, CPA and enrolled agent. There is no exclusion based on the size of the firm or its activities. In addition, the regulations may well reach beyond the concept of what most local firm and sole practitioners in the legal and accounting professions believe constitutes a "tax shelter."

For purposes of both the Code (the accuracy-related penalty standard of Code Sec. 6662) and the Circular 230 "opinion standards," the tax shelter definition includes ".....any other plan or arrangement, if a significant purpose of such.... arrangement is the avoidance or evasion of Federal income tax"

> [T]he regulations may well reach beyond the concept of what most local firm and sole practitioners in the legal and accounting professions believe constitutes a "tax shelter."

Estate Planning Subject to the New Opinion Standards

A significant difference between the Circular 230 definition and the Code Sec. 6662 definition of a tax shelter is that Circular 230 speaks to a "significant purpose of such … arrangement is the avoidance or evasion of *any tax imposed by the Internal Revenue Code*" (emphasis supplied)

Because a *significant* purpose of nearly every estate plan of consequence is the avoidance of tax (often both as to estate tax and income tax), and because an estate plan is by definition a plan (or arrangement), virtually every estate plan may be subject to the new opinion standards in some manner.

For example, the proposal that a client establish a family limited partnership or create charitable lead or remainder trusts clearly falls within the purview of the Circular 230 opinion standards, although for various reasons the advice may be ultimately be excluded from the covered opinion requirements.

Family Lawyers and Litigation Specialists

Family law practitioners and litigation specialists, particularly, are likely to find their advice subject to the covered opinion standards—again, the rules provide no exception for the particular specialty discipline of a lawyer or CPA—because family lawyers often deal with tax issues such as property transfers, spousal support and dependency issues, and litigators often deal with settlement and judgment matters that have federal tax implications.

What's the Deal Here? What's the Issue? Keeping Our Eyes on the Ball

The purpose of providing written advice to clients (taxpayers) is to provide the client an evaluation of the tax consequences of entering into a plan or arrangement, or reporting or excluding an item on a return or deducting an item. Also, with respect to favorable opinions concerning tax treatment of an item, the client usually expects us to provide "insurance," in the form of written tax advice, that asserts that if the client follows that advice with respect to reporting of items on the return, he or she will not incur a penalty if the IRS later successfully challenges the client's treatment of the item on the return.

In order to successfully provide that "insurance," the tax advisor must now comply with the opinion and written advice standards of Circular 230.

The New Circular 230 Best Practices Provision

The preamble to the regulations state that the "best practices" provision is *aspirational in nature* and that a practitioner who fails to comply with best practices will not be disciplined under the regulations.

> **Observation.** While a practitioner may not be disciplined under the best practices provision, this does not mean that discipline for violations of other provisions that arise from a failure of "best practice" standards will not be the subject of discipline.

There is a strong belief—among some members of the tax bar and CPAs—that the IRS is providing tax professionals an opportunity to take the lead in voluntarily establishing best practices. It is difficult to believe, in light of the current financial industry regulatory climate, that best practice will not become "enforceable" in the future if the professional organizations of CPAs and attorneys fail to take the initiative in providing guidelines for best practices and engaging in self-policing of their respective professions. Enrolled agents are solely subject to discipline under Circular 230.

The preamble states: "Although best practices are solely aspirational, tax professionals are expected to observe these practices to preserve public confidence in the tax system." There appears to be a strong message in those words.

What Are Best Practices? (Circular 230, Sec. 10.33)

Essentially, the IRS is concerned with practices in providing advice to clients and in preparing, or assisting in the preparation of, information submitted to IRS. They include:

- communicating clearly with the client regarding the terms of the engagement;
- establishing the facts, determining their relevance, evaluating the reasonableness of assumptions and representations, relating the applicable law to the relevant facts, and arriving at a conclusion supported by the law and facts;

> **Caveat**. This provision is not necessarily a "written advice or tax shelter opinion" standard but also includes "tax preparation" or examination representations to IRS under the "due diligence" provisions of Circular 230, Sec. 10.22.

- advising the client of the import of the conclusions reached—including, for example, whether the client may rely on the advice to avoid accuracy-related penalties under the Code; and

> **Caveat.** Again, this is not to be interpreted narrowly, but will reach all "advice" including, for example, the placement of an item (or omission of an item) from a return.

- acting fairly and with integrity in practice before the IRS.

> **Comment.** The tax practitioner has an obligation under every conceivable standard to act "honestly" with, and respectfully toward, the IRS; it is difficult to discern what the intent of "fairly" is intended to convey. This is not an academic question; practitioners frequently debate what they should do in various situations when they are representing a client before the IRS. And often, there is no general consensus to the resulting course of action a practitioner may take.

Supervisory Responsibility Under Circular 230, Sec. 10.33(b) and Sec. 10.36

Tax practitioners with the responsibility for oversight of a firm's tax practice or function must take reasonable steps to ensure the firm's compliance with best practices.

In addition to responsibility to ensure best practices, Circular 230, Sec. 10.36 provides that any practitioner with principal authority and responsibility for overseeing the firm's practice of providing written advice—"Covered Opinions"[5] and "Other Written Advice"[6]—must take reasonable steps to ensure that the Firm has in place adequate procedures to ensure compliance with those standards by all members of the firm, including associates and employees.

Reckless, willful disregard or gross incompetence on the responsible practitioner's part, or knowledge of a pattern or practice of noncompliance by members, associates or employees of the firm may result in disciplinary action against the firm by the OPR.

> **Comment**. The fact is that in order to ensure overall firm (no matter the size) compliance with best practices, some overall "quality control" structure (however informal) should be in place at the firm (or for the sole practitioner).

The AICPA Tax Division has recognized this and has undertaken a project to create a Statement of Standards for Tax Services that will address the issue of Quality Control for Tax Practice; it can be anticipated that the American Bar Association Tax Section will also address the issue.

New Circular 230 Provisions for Covered Tax Opinions and Other Written Advice[7]

At first impression, running the gauntlet of the "covered opinion" rules can be intimidating. However, the fact is that—to the extent the "everyday practitioner" outside the narrow tax shelter "industry" is affected by the covered opinion standards—only one of the six categories of covered opinions will have much impact (*i.e.*, a "Reliance Opinion"). For the general practitioner, the general "other written advice" standard (Sec. 10.37) will govern his or her practice. [8]

Six Categories of "Covered Opinions"

There are six categories of "covered opinions" (*i.e.*, two specific categories and another category consisting of four types of opinions):[9]

1. opinions concerning federal tax issues arising from a ***listed transaction***
2. opinions concerning federal tax issues arising from any plan or arrangement, the ***principal purpose*** of which is the avoidance/evasion of tax
3. opinions concerning federal tax issues arising from any plan or arrangement a ***significant purpose*** of which is the avoidance/evasion of tax *and* the advice is a
   - reliance opinion,
   - marketed opinion,
   - subject to conditions of confidentiality, or
   - subject to contractual protection

A ***federal tax issue*** must be the subject of the opinion. That means a question concerning the Federal tax treatment of an item of income, deduction, gain, loss or credit. A *federal tax issue is significant* if the IRS has a reasonable basis for a successful challenge of the issue and its resolution could have a significant impact on the overall federal tax treatment of the matters addressed in the opinion.

The provision extends to written advice and includes electronic communications (e-mail).

Written Advice Specifically Excluded from the Covered Opinion Provisions[10]

Specific exclusion from the covered opinion provision is made for *qualification of a qualified plan*, written advice included in an *SEC filing* or a *State or Local bond opinion* (subject to a separate written advice provision—unless opinions of this nature involve listed or principal-purpose transactions, arrangements, plans or entities).

Preliminary advice is also excluded when it can reasonably be expected that subsequent written advice that satisfies the covered opinion standards will be provided to the client. It should be noted that the provision does not appear to require that the subsequent advice be provided by the practitioner proffering the preliminary advice.

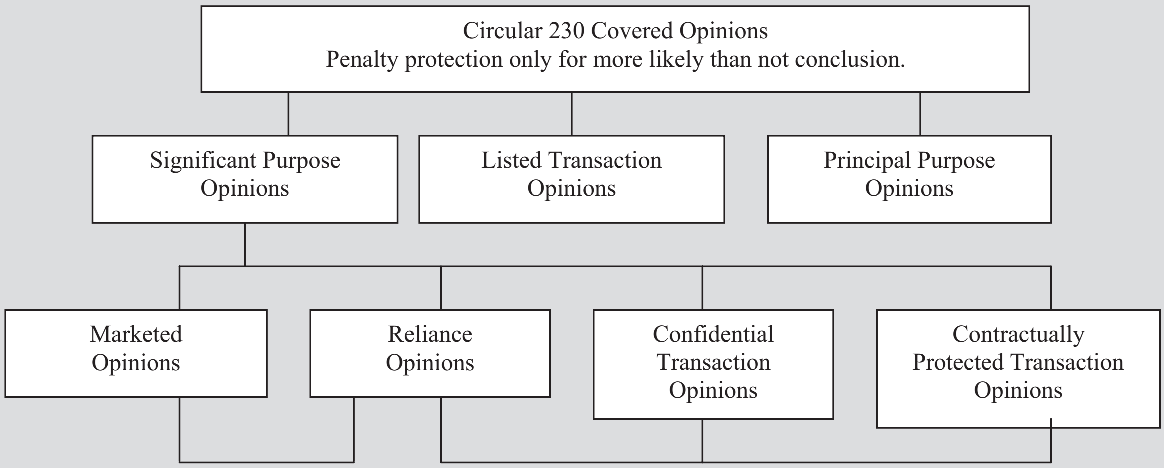
The Treasury amended the regulations on May 19, 2005, to also exclude:

- "*in-house counsel" advice*
- *negative advice* (just saying no is not a covered opinion)
- advice pertaining to federal tax issues where *the law contemplates that a principal purpose* for undertaking the transaction is the tax benefit to be derived
- *post-filing advice* (solely for use by the taxpayer) given after the tax return is filed; this would not include, however, advice that will be used in con-

Exhibit 1

Circular 230 – Section 10.35
Six Categories of Covered Opinions

The "covered opinion" rules only apply to written advice. Written advice includes electronic communications (email and text). To be a "covered opinion," the written advice must address one or more Federal tax issue(s) in connection with any one or more of six categories of transactions.



Permitted "opt out" of rules
If "opt out," then no penalty protection available
*[Marketed opinion must reach overall "more likely than not" conclusion for **each** significant Federal tax issue or opt out]*

<u>Limited scope opinion may be provided</u>

<u>Exclusions</u>

SEC documents
Qualification of qualified plan
Negative advice
Principal purpose of tax avoidance intended by statute
In house counsel advice
Post-filing advice
State/local bond advice (separate Regulations)
.Preliminary advice (where written advice expected to follow)

"Significant Purpose"

Code Section 6662(d)(2)(C) REDUCTION NOT TO APPLY TO TAX SHELTERS (emphasis supplied)

(i) IN GENERAL – Subparagraph (B) shall not apply to any item attributable to tax shelter
(ii) TAX SHELTER – For purposes of clause (i), the term "tax shelter means –
(I) A partnership or other entity,
(II) Any investment plan or arrangement, or
(III) 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.

Identical to the wording used in Section 10.35 of Circular 230 (except word "income")

"Federal tax issue"

Treatment of an item of income, gain, loss, deduction or credit, the existence or absence of a taxable transfer of property, or the value of property for federal tax purposes. *<u>Significant Federal tax issue</u>* means the IRS has a reasonable basis for a successful challenge of the treatment and it will have a significant impact on the overall tax treatment of the transaction(s) or matter(s) addressed in the opinion.

nection with future return positions or amended returns claiming benefits subject to the advice to be filed after the advice is rendered.

Removal of Penalty Protection Is the Objective; More-Likely-Than-Not Is the Standard

The principal objective of the opinion standards is to require a "more-likely-than-not" threshold for a practitioner's opinion to enable a taxpayer to avoid penalties in the event the IRS successfully challenges the taxpayer's treatment of a federal tax issue.

It should be noted that often the overriding purpose of many taxpayers (and usually all tax strategy promoters or organizers) in seeking a tax opinion is "penalty protection."

If an opinion does not reach a "more-likely-than-not" conclusion, the opinion must prominently disclose that fact and also disclose that the opinion was not written, and cannot be used, for penalty protection. This is common to all covered opinions.

If an opinion does not reach a "more-likely-than-not" conclusion, the opinion must prominently disclose that fact and also disclose that the opinion was not written, and cannot be used, for penalty protection.

Listed Transaction and Principal Purpose Opinions

Listed transaction and principal purpose (the evasion or avoidance of federal tax) opinions are clearly opinions issued with respect to "structured" (or "technical") tax shelters of the type about which there has been a great deal of publicity.

Listed transactions are those transactions (or substantially similar to such transactions) determined by the IRS to be a tax avoidance or evasion transaction, and identified by publication as a listed transaction under Reg. §1.6011-4(b)(2). The transaction is required to be listed at the time the advice is rendered.

Principal purpose transactions are any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the *principal* purpose of which is the avoidance or evasion of ANY tax imposed by the Internal Revenue Code. A purpose becomes "principal" when the purpose of avoidance of tax exceeds any other purpose of the partnership or entity, investment plan or arrangement.

Exception. There is an exclusion from principal purpose characterization IF the partnership or entity, investment plan or arrangement has as its purpose *the claiming of tax benefits in a manner consistent with the statute and Congressional purpose.*

Comment. Exclusion for undertaking a principal purpose strategy or transaction consistent with the statute and Congressional purpose does not necessarily completely remove the transaction from the reach of the covered opinion provisions. The exclusionary provision cautions the practitioner that the transaction must still run the gantlet of the four additional definitions of opinions subject to the covered opinion rules discussed below (particularly the *reliance opinion*). However, as will be seen, once removed from principal purpose characterization, the advice may be removed entirely from the scope of the opinion standards, because it does not involve a *federal tax issue* (defined below), or it may be addressed in whole or in part in "limited scope opinion" (also discussed below).

Significant Purpose Opinions

Marketed opinions are generally opinions that will be provided to third parties by an organizer or promoter of a tax strategy. If the opinion states that it cannot be used for penalty protection, was written for promotional purposes and advises the taxpayer to seek independent tax advice, it is not a marketed opinion.

Caveat. A marketed opinion must reach a "more-likely-than-not" conclusion with respect to each significant federal tax issue, or the practitioner is prohibited from providing the opinion *and*, despite reaching such a conclusion, the opinion must disclose that it was written for the promotion or marketing of the matters addressed in the opinion and advise the taxpayer to obtain advice based on the taxpayer's particular circumstances from an independent tax advisor.

Subject to condition of confidentiality, some opinions are of the notorious type that prohibit the recipient from disclosing the opinion writer/practitioner's tax strategies. These were quite common in the marketing of what IRS has deemed to be "abusive tax shelters" (several of which have not actually been legally tested in the courts).

Contractual opinions are opinions that provide full or partial refunds of fees if all or part of the intended tax results are not sustained, or where the fees paid to the tax practitioner are contingent upon realization of the tax benefits from the transaction.

Reliance opinions are opinions that conclude that it is "more-likely-than-not" that one or more significant federal tax issues will be resolved in the taxpayer's favor (if the federal tax issue is not significant, no reliance opinion exists; this is likely intended to exclude advice with respect to items involving smaller amounts of tax).

Opt-Out for Reliance and Marketed Opinions

Written advice is not a ***reliance opinion*** or ***marketed opinion*** if the practitioner prominently discloses in the opinion that it is not intended or written to be used by the taxpayer for the purpose of avoiding penalties. With respect to ***marketed opinions***, the regulation also requires that the note that the opinion was written to support the promotion of the transactions discussed and direct the taxpayer to seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Prominently Disclosed

"Prominently disclosed" means disclosure is readily apparent to a reader of written advice. The style of disclosure depends on the facts and circumstances, the sophistication of the taxpayer and the length of the written advice. *At a minimum*, "prominent" means disclosure is set forth in a separate section (and *not* in a footnote) in a typeface that is the same size as, or larger than, the typeface of any discussion of the facts or law in the written advice.

Comment. It would appear that while a tax professional may "opt-out" of the covered opinion standards for certain types of opinions, the tax professional still must comply with the "other written advice" standards of Circular 230, Sec. 10.37 discussed later, even if penalty protection is not provided.

Limited Scope Opinions

As discussed below, an opinion must consider all significant federal tax issues. An opinion that considers less than all the issues can be provided in the case of reliance, confidential or contractual opinions (but not listed transaction, principal purpose or marketed opinions) if the following requirements are satisfied:[11]

- There is an agreement between the practitioner and taxpayer that confines penalty protection (if any) to the federal tax issues addressed in the opinion.
- The opinion discloses that (a) it is limited to one or more significant federal tax issues addressed in the opinion, (b) additional issues may exist that could affect the federal tax treatment of the matters subject to the opinion, (c) the opinion does not consider or provide a conclusion with respect to those issues, and (d) penalty protection is not provided for federal tax issues outside the limited scope of the opinion.

Competence and Reliance on Opinions of Others[12]

Not surprisingly, practitioners are required to be knowledgeable about *all* aspects of the federal tax law relevant to the opinion being rendered.

Importantly, as well, if a practitioner intends to rely on the opinion of another practitioner with respect to one or more federal tax issues, the "relying" practitioner's opinion must identify the other opinion and present the conclusions reached in the other opinion. Moreover, the relying practitioner must be satisfied that the combined analysis of the opinion, taken as a whole, and the overall conclusion satisfy the requirements of the "covered opinion" standards.

Reliance Opinions–Troublesome Creatures

The intended (by IRS) scope of the reliance opinion standard is troublesome for the "everyday practitioner" when providing advice (including e-mail advice) to his or her clients.

This occurs because of the potentially long reach of the definition—"*A **significant purpose*** of an entity, plan, or arrangement is tax avoidance/evasion." This definition is taken from the "tax shelter" definition of the taxpayer accuracy-related penalty.[13] However, while IRS representatives tell practitioner groups to use "common sense" in the applying the rules, and one would thus hope this means the reliance opinion rules will not be extended to non-tax shelter type transactions, a liberal interpretation of the meaning of "significant purpose" could reach non-tax shelter advice (and surely typical, run-of-the-mill estate planning advice). Certainly, absent more extensive examples, and more specific language from the IRS about how the IRS will interpret the provision, practitioners are advised to err on the side of caution in providing written advice to clients that may become subject to these provisions.

Substantial Authority Opinion[14]

For non-tax shelter treatment of an item on a tax return, the threshold for penalty avoidance has long been, and remains that the taxpayer have "substantial authority"[15] for taxpayers' treatment of the item; therefore, this has historically been the opinion "standard" in advising a taxpayer with respect to penalties. One must be hopeful that the IRS will not challenge practitioners under Circular 230 opinion standards with respect to written advice intended to provide penalty protection, where such advice would have been appropriate under the statute prior to issuance of the new Circular 230 regulations.

Requirements for Covered Opinions[16]

Circular 230, Sec.10.35(c) sets forth requirements to be followed in the process of issuing covered opinions that include:
a factual evaluation, relating the law to the facts

- an evaluation of significant federal tax issues (with special rules for marketed opinions and permission to issue limited scope opinions in the case of confidential, contractual or reliance advice)
- provide an overall conclusion (a marketed opinion *must* reach a "more-likely-than-not" conclusion
- in other cases, if a "more-likely-than-not" conclusion is not reached, the practitioner *must* state the reasons for the inability to reach such a conclusion

Particular attention is paid to the "factual evaluation" because many of the most egregious "tax shelter" and other tax avoidance opinions rely on questionable factual assumptions (including whether a valid business purpose and economic risk truly existed).

Disclosures[17]

The written advice must disclose any relationship between the promoter and the practitioner. Marketed opinions must disclose that they are such. Limited scope opinions must disclose that they are limited in scope and that other issues of consequence may exist that the advice does not consider and for which penalty protection is not afforded. With respect to opinions that fail to reach a "more-likely-than-not" conclusion, that fact must be prominently disclosed along with the fact that the opinion cannot be used by the taxpayer to avoid penalties.

Requirements for Other Written Advice (Circular 230, Sec. 10.37)

Most tax advice rendered by CPAs should fall within the scope of Sec. 10.37. Generally, this includes written advice intended to provide clients assurance that accuracy-related penalty of Code Sec. 6662 will not be successfully imposed by IRS because there is "substantial authority" for the taxpayer's treatment of the item, or there is a "reasonable basis"[18] for the taxpayer's treatment of the item and appropriate disclosure is made in the return.

The "due diligence" requirements under this provision are not as stringent as the requirements under the "covered opinion" provisions discussed above. Nonetheless, these standards raise the bar somewhat from what some tax professionals may have been accustomed to.

The practitioner must not give written advice *if* the advice

- is based on unreasonable factual or legal assumptions, including assumptions about future events
- unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person
- does not consider all relevant facts that the practitioner knows *or should know*
- does not take into account (in evaluating a federal tax issue) the possibility that a return will not be audited, or that an issue will not be raised on audit, *or that the issue will be resolved through settlement if raised.*

The last italicized language highlights a troublesome requirement and will hold the possibility, if not the certainty, of adversely interfering with the practitioner's relationship with the client and constrain the practitioner from offering legitimate tax analysis. Clearly, this type of advice may be rendered with respect to advice concerning positions where there is less than a 50-percent chance of the taxpayer prevailing in a judicial proceeding (but where there is sufficient justification for the taxpayer's treatment of the item to avoid imposition of the accuracy-related penalty). In such situations, once the penalty issue is addressed, the next words out of the client's mouth invariably are "what are the chances of negotiating a compromise or settlement with respect to the federal tax consequences of the treatment?"

Performing that analysis and communicating it to a client is a perfectly legitimate function for the tax professional.

The IRS position is overreaching, as it suggests the tax professional tell the client "I can't consider that issue and if I did discuss it with you, I'd have to kill you to eliminate a witness to a violation of Circular 230."

Overview of Circular 230

The Five Subparts of Circular 230

Circular 230 Consists of five subparts—A, B, C, D and E. Subpart A describes the rules governing authority to practice before the IRS and explains who is entitled to practice before the IRS, who is eligible to practice as an enrolled agent or enrolled actuary, and how one applies for enrollment. It also discusses limited practice before the IRS that is permitted under some circumstances.

Subpart B discusses the duties and restrictions relating to practice before the IRS, including requirements to disclose information to the IRS, diligence as to accuracy, fee and solicitation restrictions, conflict of interest issues and standards for advising with respect to tax return positions. It also addresses practice of law issues and tax shelter opinions.

Subpart C provides sanctions for violations of Circular 230.

Subpart D sets forth detailed rules for the conduct of disciplinary actions and proceedings in connection with violations of Circular 230.

Subpart E contains miscellaneous procedural rules.

The Conduct Standards of Circular 230

Individuals Practicing Before the IRS

Subpart B of Circular 230 contains the conduct standards that govern individuals in their practice before the IRS. It addresses requirements to disclose information to the IRS, diligence as to accuracy, fee and solicitation restrictions, conflict of interest issues and standards for advising with respect to tax return positions. It also addresses practice of law issues and tax shelter opinions. All practitioners that represent taxpayers before the IRS should have a comprehensive working knowledge of the rules, restrictions and requirements, as set forth in Subpart B.

Information to be Furnished to the IRS[19]

Upon request, those authorized to practice before the IRS may not neglect or refuse to submit records or information to the IRS, nor shall they interfere with any lawful effort on the part of the IRS to obtain records or information pertaining to any matter. Furthermore, a practitioner may not attempt to, or interfere with any proper and lawful effort by the IRS or its representatives to obtain any record or information.

Privilege Exception. An exception to the information requirement is made when the practitioner believes, in good faith and on reasonable grounds, that the information sought is privileged.

> **Example**. The IRS might request that a practitioner provide written notes of communications pertaining to tax planning that were made during the course of a year that is later audited by IRS. The client may contend that the information is privileged and assert that the practitioner is not required to provide the information to the IRS. If the practitioner believes the assertion to be made in good faith, he or she may withhold the information. In such cases, the IRS, if it believes that it is lawfully entitled to the information, may proceed to seek a court ordered solution.

When the requested records are not in the possession of, or otherwise under control of the practitioner or the practitioner's client, the practitioner is required to notify the IRS of any information he or she has concerning the identity of any person that he or she believes may have control of the documents or requested information. The practitioner is also required to make reasonable inquiry of the client as to the identity of any person that may have the records. However, the practitioner in not obligated to inquire of any other person concerning the records, nor is the practitioner required to independently verify any information provided by the client regarding the identity of such person.

Practitioners are required to furnish, when requested, information to the Director of Practice concerning an alleged violation of the rules of Circular 230 by any person. Practitioners are also required to testify regarding the information in any proceeding instituted by the Director. An exception is made for such inquiries where the practitioner believes, in good faith and on reasonable grounds, that the information requested or testimony sought is privileged.

July 2002 Revisions to Circular 230

A July 2002 revision to Circular 230 made two changes in this area. They eliminated the exception that was provided for refusal to provide records or information based on doubtful legality of an information request. And, they added a requirement that authorized practitioners provide the IRS Director of Practice (upon request) with any information not only about a violation of the Circular 230 rules, but also an "alleged violation" of those rules.

Comment. Several organizations, including the ABA and AICPA, expressed concern about the deletion of the "doubtful legality" standard. They pointed out that, absent that exception, practitioners have an unconditional obligation to provide the information, absent a reasonable basis for asserting privilege. The ABA was concerned that while taxpayers may challenge the enforceability of a summons in federal court, the revisions may effectively deny practitioners a similar right.

The ABA also pointed out that the proposed revision that required practitioners to furnish the IRS information, where the privilege exception is inapplicable, is too broad. The ABA argued that it might place a practitioner in the untenable position of violating the rules by remaining silent or disclosing information that may violate a client's rights and privileges.

Despite the concerns of the commentators, the IRS essentially finalized the provision as drafted.

The IRS explanation on the final regulation stated that the "doubtful legality" test is effectively preserved because the provision requires that IRS requests be "proper and lawful." Consequently, the IRS believes that the term "doubtful legality" is redundant. In its "Explanation of Provisions" accompanying the latest revisions, the IRS clearly indicates that it did not intend to effectuate a substantive change with regard to a practitioner's ability to challenge IRS attempts to obtain documents on the basis that they were "irrelevant, confidential, privileged or otherwise immune from compulsion."

Knowledge of a Client's Omission[20]

There may be situations where an individual authorized to practice before the IRS discovers that the client has not complied with the tax laws of the United States, or has made an error in, or omission from, any return or other document that is required by law. In such instances, the practitioner is required to notify the client of the noncompliance, error or omission. The July 2002 revisions added a requirement that the practitioner must advise the client of the consequences provided in the Code or regulations resulting from the noncompliance, error or omission.

Comment. Both the ABA, in a Standards of Tax Practice Statement, and the AICPA, in a Statement on Standards for Tax Services, also require the practitioner to advise his or her client of an error, or errors, of items reflected on, or omitted from, a client's income tax return.

Diligence as to Accuracy[21]

Authorized practitioners must exercise due diligence in preparing all returns and documents relating to IRS matters, in making oral or written representations to the IRS and in making oral and written representations to a client regarding any matter administered by the IRS.

Work Product of Another Practitioner. A practitioner is presumed to have exercised due diligence if the practitioner relies on the work product of another person and the practitioner uses reasonable care in engaging, training and evaluating that person—taking into account the relationship between the practitioner and the person. Common sense and experience should guide practitioners in their conduct under the due diligence provision. The rule applies both in the context of the practitioner's firm and in circumstances involving a practitioner's hiring of an outside practitioner.

These due diligence rules do not apply to standards for advising on tax return positions (and for preparing or signing returns) and for "more-likely-than-not" tax shelter opinions. These are each dealt with in other revised sections of Circular 230.

Prompt Disposition of Matters Before the IRS[22]

Practitioners may not unreasonably delay the prompt disposition of any matter before the IRS.

Comment. Recently, the IRS has indicated that it is very serious about its intention to receive prompt responses from taxpayer representatives. In a *Memorandum For Examination, Area*

Directors, K. Steven Burgess, IRS Small Business Self-Employed Director, Examinations, addressed the topic of "Procrastinating Taxpayer Representatives" with the intention of reinforcing and highlighting the procedures available to field examiners when faced with dilatory tactics by taxpayer representatives.

While the Memorandum targets authorized representatives that have failed to respond to "repeated attempts" to schedule appointments or to obtain requested information, there is at least anecdotal evidence in the practitioner community that some examiners and group managers are quite liberal in accusing representatives of delays and the IRS's intention to by-pass the representative's power of attorney (POA) in dealing with the taxpayer. In addition, the Memorandum informs examiners and group managers that "Circular 230 is an effective tool and should be referred to when SB/SE examiners are dealing with procrastinating representatives.… A referral to the Office of Professional Responsibility should be considered if the situation warrants."

Many practitioners complain that the Memorandum is being cited in situations where it is not warranted. Moreover, some representatives complain that the language with respect to Circular 230/OPR has been improperly used in manner that represents a threat to the representative when representative's conduct clearly does not warrant it.

Conflicts of Interest[23]

Authorized practitioners are prohibited from representing taxpayers in situations where there may be a conflict of interest, except where the practitioners reasonably believe that they are able to provide competent and diligent representation to each affected client. A conflict of interest exists when the representation of one client will be adverse to another client, or if there is a significant risk that representation of one client will be materially limited by the practitioner's responsibilities to another client, former client, third person, or his or her personal interest.

Furthermore, the conflict of interest rules require that representation must not otherwise be prohibited by law, full disclosure must be made to all directly interested parties and all affected clients must provide their express written consent for representation. A practitioner must retain copies of all written consents for three years from the date of the conclusion of the representation and provide them to any IRS employee on request.

Comment. In the "Explanations of Provisions" portion of T.D. 9011 that authorized the 2002 changes to Circular 230, the IRS stated that the conflict of interest rules were modified to more closely conform to the revised Model Rule 1.7 of the ABA Rules of Professional Conduct.[24]

In the original proposed revision to Circular 230, the practitioner was prohibited from rendering services in situations where a "potential" conflict existed. This approach was strongly criticized by several organizations including the ABA and the AICPA and was removed in the final version.

Caution. Although the removal of the potential conflicts provision narrowed conflict of interests to situations where the parties' interests are directly adverse, practitioners are advised to identify potential conflicts in all tax engagements. A careful determination of potential conflicts will identify those situations where the probable risk that a directly adverse situation will arise is of sufficient magnitude that the practitioner may well be advised to withdraw from, or not accept an engagement, or parts of an engagement.

Conflicts of interest, and potential conflicts of interest, are often far more pervasive than most practitioners recognize. This often occurs when several parties are involved in a common enterprise or relationship, and little thought is given to situations where their interests may vary or conflict. When these situations arise, practitioners can find themselves squarely in the middle of a tug of war between the once amicable, and now conflicting, parties.

Commonly, these situations include possible conflicts involving married couples, family relationships involving business entities, partner/partnership tax issues, and corporation and officer/shareholder issues. The practitioner should evaluate the potential for conflict at the initial stages of the engagement to prevent problems from arising at a later time.

Another area of concern may arise in connection with preparation of returns, or in giving advice in connection with tax return preparation. Upon subsequent examination of the returns by the IRS, issues related to potential taxpayer penalties might arise that would place the practitioner squarely in conflict with the client. This may happen, for example, when there is an error in the return that puts the client in jeopardy for assessment of the accuracy-related penalty. The practitioner may be tempted to try and handle the entire matter in order to attempt to mitigate his or her own exposure to practitioner penalties or IRS discipline. This, however, would be a situation where a prohibited conflict exists between the client and the personal interest of the practitioner.

> **Comment.** Some tax practitioners send mailings offering their services to taxpayers against whom, federal tax liens have been filed. Those practitioners are required to indicate the source of their information (*i.e.,* public records) that generated the communication.

Standards for Advising with Respect to Tax Return Positions and for Preparing and Signing Returns[25]

Restrictions on Signing a Return. An authorized practitioner may not sign a return as preparer if the practitioner believes that the return contains a position on the tax treatment of an item that does not have a realistic possibility of being sustained on its merits. (This is virtually identical to the rule contained in Code Sec. 6694.) Circular 230 provides an exception to this general mandate when the position taken is not frivolous and is adequately disclosed to the IRS. The practitioner is also required to advise the client of any opportunity to avoid, by adequate disclosure, the accuracy-related penalty imposed on taxpayers by Code Sec. 6662.

> **Caution.** It is to be noted that the return position rule with respect to preparer penalty protection under Circular 230 and Code Sec. 6694 is different than the standards with respect to providing clients written advice (discussed previously) that protect a client from taxpayer penalties. Consequently, the practitioner may enjoy a lower "reporting standard" than the client. Because of this, to prevent the possibility of a conflict of interest, the practitioner must take care to ensure that the client is advised of the client's reporting responsibility with respect to the potential imposition of penalties

Adequate Disclosure. "Adequate disclosure" has evolved to include several methods over the years. The IRS periodically (generally, on an annual basis) issues revenue rulings that list items that are considered "disclosed" because they are specifically required to be shown on income tax returns in such a manner that they are readily identifiable. Other items may be disclosed by the filing of a disclosure form or by means of a clearly referenced statement in the tax return to which it relates.

Duty to Inform Client of Potential Penalties. In advising a client to take a position on a tax return (or in preparing or signing a return a preparer), a practitioner must inform the client of taxpayer penalties likely to apply to the client. The practitioner is also required to advise the client of any opportunity to avoid the accuracy-related penalty under Code Sec. 6662 by disclosing the position taken on the return and the requirements of adequate disclosure.

> **Comment.** The requirement to inform the client applies even in situations where the practitioner may not be subject to a penalty with regard to the position taken on the return (*e.g.,* where the client/taxpayer has a higher standard of disclosure than the practitioner).

Reliance on Client Information. In advising a client, a practitioner is entitled to rely on information supplied by the client in connection with positions taken on income tax returns. Generally, a practitioner may rely in good faith on information supplied by the client without further verification. Nonetheless, the practitioner may not ignore the implications of client-provided information if it appears incomplete, incorrect or inconsistent, and must make reasonable inquiries to insure the accuracy of the position taken in such circumstances. This is also true when the practitioner has actual knowledge of information that contradicts or affects the treatment of information furnished by the client.

Disciplinary Proceedings

Sanctions for Violation of the Circular 230 Regulations[26]

The Treasury Department is authorized to censure, suspend or disbar any authorized practitioner if the practitioner is (1) shown to be incompetent or disreputable; (2) refuses to comply with the rules and regulations of Circular 230; or (3) willfully and knowingly deceives, misleads or threatens a prospective client by oral or written solicitation with intent to defraud.

Monetary penalties. In addition, the American Jobs Creation Act of 2004 amended 31 USC 330 to provide for the imposition of monetary penalties upon representatives for violations of the Circular 230 regulation. The penalty's upper limit is the gross income derived from the conduct subject to discipline. Moreover, if the representative's employer, firm or entity knew of, or merely had reason to know of such conduct, a separate penalty may be imposed on the employer, firm or entity subject to the same upper limitation.

Examples of Disreputable Conduct

Twelve examples of disreputable conduct are specifically cited in Circular 230:[27]

- conviction of any tax crime or a crime involving dishonesty or breach of trust
- conviction of any criminal offense involving dishonesty or breach of trust
- conviction of any felony under federal or state law for which the conduct involved renders the practitioner unfit to practice before the IRS
- soliciting employment as prohibited under Circular 230, Sec. 10.30, and the use of deception or false or misleading representations in seeking clients or intimating that the practitioner enjoys a special relationship with the IRS
- giving false or misleading information or participating in the giving of false or misleading information to any IRS employee or officer, or to any tribunal authorized to pass upon federal tax matters (This applies in connection with any matter pending or likely to be pending before them. Facts or other matters contained in testimony, federal tax returns, financial statements, applications for enrollment, affidavits, declarations, or any other document or statement written or oral, are considered information)
- willfully failing to file a tax return, engaging in tax evasion or participating in any way in evading or attempting to evade a tax for the authorized practitioner or a client
- misappropriation of, or failure to remit properly and promptly, funds received from a client for payment of tax and other federal obligations
- attempting to bribe IRS officials
- disbarment or suspension from practice as an attorney, CPA or public accountant by a state
- assisting a disbarred or suspended person in practicing before the IRS
- contemptuous conduct in connection with practice before the IRS (This includes the use of abusive language, making false accusations and statements knowing them to be false, or circulating or publishing malicious or libelous matter)
- giving a false tax opinion; knowingly, recklessly, or through incompetence, giving an opinion that is intentionally or recklessly misleading; or a pattern of providing incompetent opinions on tax questions

Comment. It is important to note that any suspension from practice as an attorney, CPA or public accountant results in a suspension from practice before the IRS, because the practitioner no longer meets the qualification standards to practice. Thus, an attorney, CPA or public accountant who is suspended (or disbarred) from practicing under state law for conduct violations outside the tax arena will, nonetheless, be unable to practice before the IRS.

Additional Grounds for Discipline[28]

Additionally, an authorized practitioner may be disbarred or suspended for willful violation of any of the regulations contained in Circular 230, specifically including, through recklessness or incompetence, violating the Circular 230 tax shelter standards, the standards for advising on tax return positions, and for preparing and signing returns.

Representation before the IRS

Representation of taxpayers before the IRS in an administrative proceeding typically begins during an examination of a taxpayer's federal income, estate or employment returns (of course, the practitioner may have also participated in the preparation of the taxpayer's return). The representation may continue before the Office of Appeals of the IRS in situations where the taxpayer and the IRS are unable to agree upon the tax treatment of one or more items on the taxpayer's return.

Persons authorized to practice before the IRS may represent a taxpayer before the Collection Division of the IRS in matters pertaining to the collection of assessed taxes. Tax return preparers who are not CPAs, attorneys or enrolled agents may represent the taxpayer before the Examinations Division of the IRS and provide information and explanations to the examining agent, provided they prepared the return. The IRS contemplates that an unenrolled preparer will recognize questions, issues and factual situations that are beyond his or her complete understanding due to their technical or difficult nature. In this circumstance, the unenrolled preparer should advise the taxpayer to seek additional expert assistance from a qualified professional.[29] When the examiner and the taxpayer (or the tax preparer on the taxpayer's behalf) are unable to agree to any proposed adjustments to the return, the unenrolled tax preparer may not represent the taxpayer before the Appeals Office of the IRS.

Dealing with the IRS as an Adversary. Usually, the tax professional's role on behalf of a taxpayer in an examination or appeals conference is that of an advocate for the taxpayer. This is fundamentally different than the tax professional's role in the context of return preparation, where the objective is to determine and report the correct amount of tax. On the other hand, the preparation of an income tax return often involves advocacy in the form of taking positions most beneficial to the taxpayer; in those situations, the tax professional must at least anticipate the potential for an adversarial relationship if the return is examined. In situations that primarily involve fact-finding, the tax professional might best serve the taxpayer's interest through a nonadversarial approach to dealing with IRS personnel.

> **Comment.** There are situations involving representation where the relationship will not be adversarial. Generally, in dealing with a revenue officer over an assessed tax, a nonadversarial approach is well advised. In such situations, the representative must advocate for the taxpayer to secure the most reasonable payment program possible, but acting adversarially is not likely to achieve that objective. Also, in situations involving a request for innocent spouse relief or in submission of an offer in compromise, the primary duty of the IRS personnel processing the case is to make a factual determination, followed by a recommendation for, or against, granting relief or acceptance.

Fact Finding. In many respects, the examination process is initially a fact-finding mission on the part of the IRS.[30] Only after the examining agent determines issues will advocacy come actively into play in the form of defending and arguing in favor of the positions taken on the return. Most examinations generally involve factual determinations based on well-understood tax principles and law, rather than on complex interpretations of the tax law. The tax professional in these situations is usually the advocate for the taxpayer's factual evidence[31] and, on fewer occasions, an advocate for the taxpayer's application[32] or interpretation of the tax law.[33]

In cases where the examining revenue agent and the tax professional (acting on behalf of the taxpayer) are unable to agree to adjustments proposed by the revenue agent, the relationship of the parties will naturally become that of adversaries, and it will continue as such until final resolution of the case. Additional fact-finding will be required (and often desired) if, after the examination of the return is completed, the examiner's findings are appealed. This is also the case when an adverse determination is made by Appeals and the case proceeds to litigation. All parties are best served by approaching the search for facts in a nonadversarial manner. That said, tax professionals, as part of their duties to the taxpayer, are obligated to present factual evidence and make arguments concerning the interpretation of that evidence in the manner that will best serve the taxpayer's interests.

Conflict of Interest

Circular 230, the ABA Model Code and Model Rules, and the AICPA's Code of Professional Conduct all contain prohibitions against tax professionals rendering services in a situation where a conflict of interest is present. Under these rules, the tax professional may sometimes continue to represent the client/taxpayer, provided that each affected client is informed of the conflict and gives informed consent, confirmed in writing.[34] Tax professionals must reasonably believe that they "will be able to provide competent and diligent representation to each affected client."[35]

Many potential conflict of interest situations are fairly obvious or can be foreseen.

Client Conflicts. Conflicts of interest with a client may arise from the simultaneous representation of two or more clients with differing interests, or the representation of a client whose interests differ from those of a former client. For example:

- representation of fiduciaries and beneficiaries of trusts or estates
- representation of one or more partners, former partners and partnerships, or some combination thereof
- representation of one or more shareholders, the owned corporation and former shareholders
- representation of a husband and wife in situations when the parties are contemplating or involved in divorce proceedings (or in cases where there is obvious marital discord)

- representation of multiple members of the same family when there are significant financial dealings between them or common ownership of valuable properties

Practitioner-Client Conflicts. The client is entitled to depend on the tax professional to protect his or her interests. Thus, the tax professional has a duty to ensure that all business dealings with the client are both reasonable and fair. The tax professional is also duty bound to avoid conflicts that may arise from the professional's self-interest, including both fee arrangements and any other business dealings.

Comment. A CPA (or CPA firm) must take extra precaution with regard to clients for which the CPA serves as auditor. The CPA and the firm are prohibited from engaging in most business dealings with the client during the period covered by an audit engagement. However, the CPA or firm is generally not precluded from providing tax planning, return or preparation services to the client. However, the rules with respect to providing these services to public companies and their management promulgated by the Public Companies Accounting Oversight Board under the authority of the Sarbanes-Oxley legislation can be quite restrictive. A discussion of those rules, and their impact on CPAs and CPA firms, is beyond the scope of this article. However, CPAs who serve as auditors of companies subject to U.S. Securities and Exchange Commission oversight must be thoroughly familiar with the rules and restrictions.[36]

Caution. The tax professional may also find a possible conflict of interest with the client in situations where the client asserts reliance on the tax professional under the reasonable cause exceptions to the imposition of the Code Sec. 6662 accuracy-related penalty. In such cases, the client may be entitled to the exception because of good faith reliance, but the advice may have proven to be incorrect. This might prompt the IRS to consider asserting preparer penalties. In such cases, the self-interest of the professional may make it impossible (or appear to make it impossible) for the tax professional to provide zealous advocacy of the client's position.

Tax Professional as Witness. Occasionally, an administrative proceeding will advance to the litigation stage, and, because of the nature of the dispute, the tax professional will become a witness in the proceeding. In such cases, the tax professional should consider whether to continue representing the client at the administrative stage of the proceeding, or recommend that the client retain another representative.

Fees

Circular 230 prohibits the tax professional from charging an unconscionable fee for representing a client in a matter before the IRS.[37] This rule was once interpreted as prohibiting the use of contingent fees in civil tax matters. However, Circular 230 now prohibits contingent fees only in situations involving the preparation of an original return. Amended returns, claims for refund or examination representation may be the subject of contingent fee arrangements, provided that the professional reasonably anticipates that the amended return or refund claim will receive substantive review by the IRS. ABA Model Rule 1.5(c) is the guideline attorneys should follow in charging a contingent fee for representing taxpayers in IRS examinations. CPAs are governed by an Interpretation to Rule 302 of the AICPA Code of Professional Conduct.[38]

Dealing with the IRS and Due Diligence Requirements

Under Circular 230, the tax professional is required to comply with requests for information or documents by officers and employees of the IRS and is prohibited from engaging in an unreasonable delay of the prompt disposition of any matter before the IRS. The tax professional is also required to use due diligence in preparing (or assisting in preparing), approving, and filing documents, affidavits and other papers relating to matters before the IRS. Similar requirements apply to the correctness of oral or written representations made to the IRS, and in determining the correctness of oral or written representations made to clients with reference to any matter administered by the IRS.

Furnishing Information or Producing Documents. The tax professional may raise objections to the production of documents or information based on good faith and reasonable grounds. For example, this might include objections based on the doctrine of privileged communication, or based on the work product doctrine (which provides limited protection for work product created by experts, including nonattorneys, prepared in connection with, or in anticipation of, litigation).

Unreasonable Delay. The question of what might constitute "unreasonable delay" is not specifically addressed in Circular 230. Furthermore, the time permitted for responding to requests for information or documents may vary among IRS regions, areas and territories. Consequently, a taxpayer representative should meet deadlines to the greatest extent possible. When deadlines cannot be met or other issues arise, a taxpayer representative should remain in communication with IRS personnel concerning the status of pending matters. In some cases, IRS officers or employees will disregard the professional's power-of-attorney if the IRS believes that the tax professional is engaging in unreasonable delay. As a result, the professional may not be notified before the IRS initiates direct communication with the taxpayer concerning the delay.[39]

Required Disclosure to the IRS

The IRS, the AICPA and the ABA Tax Section each address the issue of the discovery of an omission or other computational error in a matter that is the subject of an administrative proceeding. The IRS and ABA policies address errors and omissions in any return, document, affidavit or other paper that the client submitted or executed in a matter before the IRS. The AICPA statement is narrower, dealing only with the discovery of an error on a return that is the subject of an administrative proceeding. Note, however, that a CPA is subject to the broader Circular 230 requirements as well.

Comment. The ABA and AICPA standards are somewhat different. The author is of the opinion that the differences, while very real in some respects and without distinction in other respects, are the product of the different services the two professions normally provide their clients. For example, in addressing error and omissions under Circular 230, the attorney's guidance focuses on disclosures that include proceedings that have reached the litigation stage. The CPA's guidance, on the other hand, focuses on an error discovered in the return during an administrative proceeding because CPAs do not engage in litigation (except in those rare situations when a CPA passed the examination that permits practice before the United States Tax Court).

As CPAs have increasingly expanded the types of tax services they offer, there has been an escalating tension between CPA tax professionals and attorney tax professionals. Despite this, attorneys and CPAs often consult, refer to and borrow from each other's standards when seeking guidance in a particular situation involving practice standards.

The approach of the IRS, and both the ABA and AICPA, is to require that the tax professional notify the client promptly of an omission or error, or other fact of noncompliance. The professional is also required to advise the client of the consequences, as provided under the tax law, of the noncompliance, error or omission. The ABA takes a position that, when a computational error is conceptual, such that a reasonable dispute still exists concerning the calculation, there is no requirement to recommend that a possible computational error be disclosed.

Attorneys. There is no duty imposed by the IRS or the tax professional organizations to notify the IRS of an error except when an attorney is representing the taxpayer in litigation docketed for trial. In that case, the attorney is required to notify the court of error. When a case is not yet docketed, the attorney may disclose the error with the client's implied consent. If there is not implied consent and the client refuses to make disclosure, the attorney is required to withdraw from representation.

Generally, the professional rules governing attorneys are substantially the same as attorneys' responsibilities and duties under Circular 230. ABA Model Rule 4.1 requires that the attorney be truthful in dealing with third parties on the taxpayer's behalf. ABA Model Rule 3.3 requires an attorney to disclose material facts in order to prevent wrongful conduct, to disclose adverse authority and undertake "remedial measures" when he or she learns that he or she has provided false evidence.

CPAs. Where a taxpayer refuses to correct the error, the CPA is directed to consider whether to withdraw from representing the taxpayer in the administrative proceeding and whether to continue a professional relationship with the taxpayer.

Truthfulness and Adverse Authority Issues in Administrative Proceedings

The IRS is not a tribunal; it is an administrative agency. As such, it acts in the dual role as adversary and adjudicator in an administrative proceeding. Consequently, the IRS has the burden of establishing its own case against the taxpayer, and the ABA takes the position that an attorney is not required to reveal to the IRS, weaknesses in the taxpayer's case.[40] While an attorney may not make false statements or otherwise mislead the IRS, there is no obligation to reveal facts that are favorable to the IRS in an administrative proceeding.[41]

While the AICPA Statements on Standards for Tax Services do specifically address these issues, in practice CPAs have generally adopted the principles followed by attorneys with respect to revealing weaknesses in the taxpayer's case.

Comment. Basic differences exist in the functions of the CPA and the attorney. While the types of work they perform overlap, CPAs (along with enrolled agents) probably represent taxpayers in the great majority of examinations of income tax returns. If an agreement is not reached with the IRS at the examination level, the case will normally proceed to the Appeals Offices of the IRS. At this level, taxpayers will frequently retain the services of an attorney for representation before an appeals officer. This step is advisable because, when an agreement is not reached with Appeals, the taxpayer's next step is to seek judicial review of the unresolved issues.

Involvement of the attorney at the appeals level enables the attorney to be educated about the issues involved. The attorney studies the strengths and weaknesses of the taxpayer's case in an attempt to settle the matter, as well as to prepare for possible litigation of the issues. Nonetheless, taxpayer representation at the appeals level is probably equally divided between attorneys and CPAs (along with enrolled agents).

Obviously, if a case is not resolved at the appeals level of the IRS,[42] the taxpayer must retain the services of an attorney to pursue resolution in the court system.[43]

Burden of Proof and Qualified Settlement Offers

Tax professionals must be cognizant of two particular provisions of the Internal Revenue Code that have application and utility when representing taxpayers before the IRS. They are

- the opportunity to shift the burden of proof to the IRS in a Tax Court proceeding pursuant to Code Sec. 7491; and
- the opportunity, under Code Sec. 7430(g), to make a special qualified settlement offer to the IRS after the taxpayer has received the first letter of proposed deficiency that allows a review by the Appeals Office of the IRS. At this time, subject to specific rules spelled out in the statute, the taxpayer may make an offer of settlement of the deficiency. If the IRS does not accept the taxpayer's offer, the taxpayer will be entitled to recover fees and costs if the court determines liability is equal to, or less than, the amount of the offer.

Tax preparers (especially a CPA representing a taxpayer in the examination and appeals process) must be familiar with these provisions. The shift of the burden of proof is dependent on full cooperation by the taxpayer and his or her representative from the beginning of the examination.[44] Consequently, all tax preparers should be aware from the outset of an IRS inquiry that lack of cooperation with the IRS may deprive the taxpayer of the opportunity to shift the burden of proof. Tax preparers could find themselves the subject of a malpractice suit filed by a disgruntled taxpayer who contends that if the burden of proof had shifted, the taxpayer would have prevailed.

Similarly, a malpractice claim might be filed if a taxpayer representative fails to submit a qualified offer at the earliest possible opportunity. In addition, entitlement to the benefits available under the qualified settlement offer process is dependent upon full disclosure of the taxpayer's position at the Appeals conference(s) and the exhaustion of administrative remedies.

Conclusion

Based on widely disseminated public comments of the Internal Revenue Commissioner, Mark Everson and the Director of the IRS's Office of Professional Responsibility, Cono Namorato, the IRS intends—in its administration of the Federal tax system—to use significantly increased enforcement activity for substantive violations of the Circular 230 conduct standards by tax professionals as a part of its general deterrence toolkit for improving taxpayer compliance with the law. Consequently, tax professionals are advisedly cautioned to know, to understand and to comply with the provisions of Circular 230.

Endnotes

* Portions of these materials are adapted from Federal Tax Practice Standards (CCH, 2005) by Mr. Dellinger.

1 Attorneys, CPAs, enrolled agents and enrolled actuaries.

2 Amending 31 USC §330(b) and adding 31 USC §330(d).

3 American Jobs Creation Act of 2004 (P.L. 108-357).

4 December 2004, effective June 20, 2005.

5 Circular 230, Sec. 10.35, discussed below.

6 Circular 230, Sec. 10.37.

7 Circular 230, Sec. 10.35 and Sec. 10.37.

8 The authors say this "hopefully" since the broad brush of "arrangements … a significant purpose of which is the avoidance … of any tax imposed by the Internal Revenue Code" can be interpreted to cut a wide path through the world of tax practice.

9 Circular 230, Sec. 10.35(b)(2)(i).

10 Circular 230, Sec. 10.35(b)(2)(ii).

11 Circular 230, Sec. 10.35(c)(3)(v).

12 Circular 230, Sec. 10.35(d).

13 Code Sec. 6662(d).

14 Code Sec. 6662(d)(2)(B)(i) and Circular 230, Sec. 10.34.

15 Generally considered, a somewhat greater than one-in-three chance of the taxpayer prevailing in an administrative of judicial proceeding with respect to the chosen tax treatment, but less than the "more-likely-than-not"/greater-than 50 percent threshold. The "substantial authority" threshold for "advising with respect to tax return positions" remains very much alive and well, and residing at Section 10.34 of Circular 230.

ENDNOTES

[16] Circular 230, Sec. 10.35(e).

[17] Circular 230, Sec. 10.35(b)(8) and (e)(3).

[18] "Reasonable basis" has been interpreted to mean that there is a 15-to-25-percent chance that the taxpayer's treatment of the item will be sustained in an administrative or judicial proceeding. Because the "success" threshold is rather low, taxpayers are required to "disclose" such positions when taken on an income tax return.

[19] Circular 230, Sec. 10.20.

[20] Circular 230, Sec. 10.21.

[21] Circular 230, Sec. 10.22.

[22] Circular 230, Sec. 10.23.

[23] Circular 230, Sec. 10.29.

[24] T.D. 9011, IRB 2002-33, 356; 2002-2 CB 356.

[25] Circular 230, Sec. 10.34.

[26] Circular 230, Sec. 10.50.

[27] Circular 230, Sec. 10.51.

[28] Circular 230, Sec. 10.52.

[29] Rev. Proc. 81-38, 1981-2 CB 592. It should also be noted that if a carryback or carryforward is involved, an unenrolled practitioner is not recognized as the taxpayer's representative for the tax year in which the carryback or carryover arose, unless that unenrolled preparer prepared the return for that year.

[30] The original ABA opinion concerning the relationship between the IRS and lawyers practicing before it (Opinion 314) took the position that the "Internal Revenue Service is neither a true tribunal, nor even a quasi-judicial institution." Thus, the ABA concluded that, while intentionally misleading the government was prohibited under the Canons of Ethics (superseded by the Model Code and Model Rules), there was no obligation on the lawyers part to disclose information that would tend to "reveal weakenesses" in the client's case. In effect, the ABA stance was that the filing of a tax return might itself constitute the beginning of an adversarial proceeding, and many tax attorneys took just that position. When Formal Opinion 85-352 superseded portions of Opinion 314, the Report of the Special Task Force on the Opinion specifically stated that tax returns were not adversarial proceedings, instead concluding, "a tax return initially serves a disclosure, reporting and self-assessment function."

[31] For example, the tax professional handles the presentation of evidence such as contemporaneously maintained documentation to support entertainment and business meal deductions, evidence of interest or taxes paid, or business expenses incurred.

[32] For example, the tax professional argues in favor of the amount the taxpayer claims as excluded income as result of physical damages from a personal injury in accordance with allocations within a larger settlement agreement.

[33] For example, the tax professional presents the taxpayer's argument that the corporate reorganization provisions contemplated tax-free treatment of a transaction entered into by the taxpayer.

[34] Circular 230, Sec. 10.29(b); the rules of conduct of the ABA and AICPA have similar restrictions for conflict of interest situations.

[35] Circular 230, Sec. 10.29(b); The Model Code and Model Rules each contain a two-step test to ascertain when an attorney may represent one or more clients with differing interests: (1) the attorney must be able to conclude under an objective standard that adequate representation can be provided despite the differing interests, and (2) the client must consent to the representation after full disclosure. Model Rule DR 5-105(C) states that an attorney may represent clients in conflicting interest situations only "if it obvious that he can represent the interests of each."

[36] In the case of a publicly traded business subject to the jurisdiction of the S.E.C., certain limitations with respect to tax planning services apply (as promulgated by the Public Companies Accounting Oversight Board) pursuant to the Sarbanes-Oxley Act of 2002 (P.L. 107-204).

[37] Circular 230, Sec. 10.27.

[38] Attorneys and CPAs need to review the rules of their particular state of license to determine if contingent fees are permitted for various types of tax services. In addition, CPAs may be prohibited from charging a contingent fee for tax services to attest clients in situations where it would otherwise be permissible.

[39] *See, also,* the earlier discussion of the recent SB/SE Memorandum with respect to procrastinating practitioners.

[40] ABA Opinion 314 continues to apply to attorney representation in administrative proceedings; Formal Opinion 85-352 superseded it with respect to advice with respect to positions taken on tax returns.

[41] Frederic G. Corneel, *The Unofficial ABA Guidelines to Tax Practice Second*, 43 TAX LAW. 297 (1990). Mr. Corneel takes the position that a lawyer representing a client in an audit proceeding is not obligated to counsel the IRS on the applicable law.

[42] Resolution at the Appeals level includes arbitration, or mediation of cases, which are available under some circumstances when the case reaches the Appeals Office.

[43] A small number of nonattorneys have passed an examination that permits them to practice before the United States Tax Court. While they can represent the taxpayer in litigation before that Court, they cannot practice before other federal courts. Thus, the taxpayer's choice of forum is limited to the Tax Court if he or she is to be represented by the nonattorney. Moreover, if the case is appealed to the federal appeals courts from the Tax Court, the nonattorney is not permitted to represent the taxpayer before those courts. Consequently, when a nonattorney does represent the taxpayer before the Tax Court, it is advisable for the nonattorney to associate with an attorney, who may represent the taxpayer in any appeal from the Tax Court.

[44] The Conference Committee Report (H.R. CONF. REP. NO. 105-599) to the IRS Restructuring and Reform Act of 1998 (P.L. 105-206) notes that examination is defined broadly enough to encompass the matching of information returns against amounts reported on tax returns or the IRS review of a claim for refund.