

**Confidence Levels, Circular 230, and Practitioner Penalties**

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IRS news release IR-2004-152, Doc 2004-23935, 2004 TNT 244-13, explained that "the revisions to Circular 230 provide standards of practice for written advice that reflect current best practices and are intended to restore and maintain public confidence in tax professionals." Much was written about those changes while they were still in proposed form; much more will be written now that they have been finalized (T.D. 9165, Doc 2004-23933, 2004 TNT 244-4), mainly by those who are concerned about what have come to be known as tax-shelter opinions. The Associated Press release of December 17, 2004, by Mary Dalrymple, summed up the thrust of the new regulations as seen by the general public and by the bulk of the tax practice community:

The new "best practices" clamp down on opinions that tax professionals issue to taxpayers, often wealthy investors, who want to know whether a tax-sheltering strategy could be considered illegal or abusive.

But the "best practices" do not "clamp down" on anything because they are aspirational standards and not disciplinary.

### **Covered Opinions**

In this article, we are concerned less with tax shelter opinions than with that vast bulk of tax advice that is either not written or does not deal with tax shelters. Relatively few attorneys covered by Circular 230, and even fewer CPAs or enrolled agents, ever will knowingly issue what Circular 230 calls "covered opinions." So after a perfunctory discussion of "covered opinions" and matters related to them, we will turn to the effect of the new rules on the rest of the work done by the practitioner community.

"Covered opinions" include written advice, however delivered (in other words, whether by e-mail, snail mail, fax, or hand delivered), arising from:

- (1) a listed transaction (as to which see our "Practitioner 'Due Diligence' and Listed Transactions," Tax Notes, May 3, 2004, p. 553);
- (2) any plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax; or
- (3) any plan or arrangement, a significant purpose of which is the avoidance or evasion of tax if the written advice is:

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- (a) a reliance opinion,
- (b) a marketed opinion,
- (c) subject to conditions of confidentiality, or
- (d) subject to contractual protection.

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"Written advice is a reliance opinion," according to new section 10.35(b), "if the advice concludes at a confidence level of more likely than not (greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor." However, that written advice will not be treated as a reliance opinion if the practitioner "prominently discloses" in the written advice that it was "not written to be used and cannot be used for the purpose of avoiding penalties." As we interpret the language used, the more customary "substantial authority" opinion, so worded to avoid section 6662 penalties in nonshelter situations, would not be a "reliance opinion" and would not require disclaimer.

### **Run-of-the-Mill Tax Work**

Can tax practitioners continue to write substantial authority opinions that will protect clients against section 6662 penalties? Such opinions are not "reliance opinions" if they do not express a "more likely than not" confidence level. They are not any other category of covered opinion either, if they do not involve a listed transaction, a transaction with the principal purpose of evading or avoiding any tax, or a marketed opinion, and are not subject to either conditions of confidentiality or contractual protection. It thus appears that they can continue to be written.<sup>1</sup> Section 6662 has not been written out of the law, and section 6664(c) has not been modified. The IRS does intend to amend reg. section 1.6664-4 to make sure opinions cannot be used to avoid penalties if they contain the practitioner's "prominent disclosure" that the opinion was not written to and cannot be used to avoid penalties.

However, revised Circular 230 specifically does cover written advice other than covered opinions in section 10.37. First, it should be noted that there is no Circular 230 requirement that tax advice be in writing. What section 10.37 is saying is that if written advice is to be given, then:

A practitioner must not give written advice (including electronic communications) concerning one or more Federal tax issues if the practitioner bases the written advice on unreasonable factual or legal assumptions (including assumptions as to 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, or, in evaluating a Federal tax issue, takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised. All facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client will be considered in determining whether a practitioner has failed to comply with this section. 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 (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, the determination of whether a practitioner has failed to comply with this section will be made on the basis of a heightened standard of care because of the greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.

### **Due Diligence**

That is not to say that Circular 230 has no standards applicable to oral advice. To the contrary, what had been in Circular 230 all along was already quite demanding -- if it had ever been enforced. Chief among the long-standing standards has been the section 10.22 requirements of due diligence in:

(1) preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to IRS matters;

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<sup>1</sup> Note that a written opinion is not even necessary to avoid section 6662 penalties on the ground of the section 6664(c) "reasonable cause" and "good faith" exception. See our "How Taxpayers Can Void their Penalty Protection 'Insurance,'" *Tax Notes*, Jan. 26, 2004, p. 507.

(2) determining the correctness of oral or written representations made by the practitioner to the Treasury Department; and

(3) determining the correctness of oral or written representations made by the practitioner to clients regarding any matter administered by the IRS.

Even without adding anything to Circular 230, the requirement of exercising due diligence in determining the correctness of oral or written representations provided the Office of Professional Responsibility (OPR) a weapon for disciplining tax practitioners who went astray in the day-in, day-out work of the tax practitioner. We have worked with enough practitioners over the years, and reviewed enough tax files, to realize that the documentation of due diligence in determining the correctness of written representations is spotty at best, and is often nonexistent regarding oral advice.

Documentation does matter, however, when a question is raised as to the advice. A practitioner being investigated for violation of Circular 230's section 10.22 will be contacted and offered an opportunity to dispute the facts asserted by the IRS, assert additional facts, and make arguments. At that point, the lack of documentation can prove awkward. It might mean the practitioner will be reprimanded by the director of OPR. If the punishment being sought by OPR is censure, suspension, or disbarment, however, OPR must institute a formal proceeding. In the administrative hearing that may follow, OPR will have to prove its case by a preponderance of the evidence unless the sanction being imposed is disbarment or a suspension from practice of six months or longer. In the latter cases, OPR must prove its case by clear and convincing evidence in the record. With oral advice, of course, the threshold OPR problem is to establish what advice was actually given, which is an argument we have heard for oral rather than written advice. Once OPR has surmounted that hurdle, however, its burden of proof will be much easier to carry if the practitioner can produce no contemporaneous documentation of due diligence.

### **Best Practices**

Circular 230 now includes a recitation of best practices in providing advice to clients and in preparing or assisting in preparation of submissions to the IRS. Section 10.33 says best practices include:

(1) Communicating clearly with the client regarding the terms of the engagement. For example, the adviser should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.

(2) Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.

(3) Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the code if a taxpayer acts in reliance on the advice.

(4) Acting fairly and with integrity in practice before the IRS.

While section 10.52 makes clear that a practitioner cannot be censured, suspended, or disbarred from practice because of a violation of the best

practices of section 10.33, we have a suspicion that many situations involving those violations also will include a failure to exercise due diligence under section 10.22 and many will constitute violations of the tax practice standards of the American Institute of Certified Public Accountants.

### **Responsibility of Those in Authority**

Significantly, what had been strictly a practitioner-oriented approach in Circular 230 shifted in the 2004 revision to one that recognized that best practices are not merely a matter of individual behavior but are heavily affected by the culture of the organization within which the tax practitioner does his or her work. Thus, section 10.33(b) provides:

Procedures to ensure best practices for tax advisors. Tax advisors with responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices set forth in paragraph (a) of this section.

Separate and apart from Circular 230's section 10.33 aspirational "best practices," section 10.36 requires that practitioners "who have or share principal authority and responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues must take steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying" with the section 10.35 requirements for covered opinions. That is not an aspirational statement. Failure to comply may subject the practitioner(s) to Circular 230 discipline.

### **Standards and Their Enforcement**

The preamble to the final 2004 revision explained that both the best practices themselves and "the provisions relating to steps to ensure that a firm's procedures are consistent with best practices, now set forth in section 10.33(b)," are only aspirational. This is a "foot in the door" statement if we have ever seen one. Our "foot in the door" view is reinforced not only by section 10.36 but by the preamble's conclusion on this point that "although best practices are solely aspirational, tax professionals are expected to observe these practices to preserve public confidence in the tax system." The latter seems to us a rather clear invitation to the national organizations of tax practitioners to respond -- and we wonder how long it will take for the AICPA tax executive committee, the American Bar Association Section of Taxation, and the National Association of Enrolled Agents to rise to the challenge and both explain that their existing standards, in fact, embrace and go beyond those new "best practices," as well as take specific steps to bolster their standards when they may fall below those of the new Circular 230.

Thinking of the possible impact of these aspirational standards reminds us of the AICPA program of statements on responsibilities in tax practice. Launched in 1964 as strictly advisory, it merely represented the views of an experienced and informed group of CPA tax practitioners as to what constituted good practice standards. Even though the statements said they were not intended to set forth enforceable standards, pressure within the AICPA tax division membership developed over time to formally declare that the statements were enforceable standards. An attempt to do this in the early 1980s was turned down by the AICPA board of directors. However, a later overture was successful and the statements became standards in 2000.

More importantly, even though the statements were "merely" advisory for over 35 years, they quickly became a de facto standard that was often cited by expert witnesses in CPA tax malpractice matters. Judges and juries often failed to appreciate the fine distinctions defense counsel tried to draw between "best practices," "aspirational standards," and the prevailing practices to which a client had a right to assume a practitioner adhered. Some state accounting boards (for example, those in Arizona, Colorado, Florida, Idaho, Kentucky, and North Carolina) adopted the standards as presumptively setting forth acceptable practice by CPAs in the federal tax area for disciplinary purposes.

### **'Best Practices' and AICPA Standards**

The eight AICPA standards reflect the reality that while much of a CPA's tax work involves tax return preparation and tax return positions, the CPA's tax work goes beyond compliance. The first six standards involve compliance-related matters, including the minimum support necessary for a return-filing position (realistic possibility of success for an undisclosed position), failure to answer questions on returns, degree to which supporting data must be examined or verified, use of estimates, departure from a position previously concluded in an administrative proceeding or litigation involving a prior return of the taxpayer, and action to be taken when the CPA becomes aware of an error on an already filed return. Standard No. 7 involves what the CPA must do when he or she becomes aware of an error in a return that is the subject of an administrative proceeding while No. 8 deals with the form and content of advice to taxpayers.

The "best practices" of Circular 230 are, for the most part, either implicit or explicit in the AICPA standards. Thus, best practice number three deals with advice to clients and making sure the client understands whether accuracy-related penalties would be avoided if the advice was followed. AICPA Standard No. 8 also deals with advice to clients and incorporates, by reference the part of Standard No. 1 that states that a CPA should, "where relevant, advise the client as to the potential penalty consequences of the recommended tax return position and the opportunity, if any, to avoid such penalties through disclosure." Interestingly, section 10.34 of Circular 230 already requires that a practitioner advising a client on a tax return position, including preparation of part or all of a return, must be advised of "penalties reasonably likely to apply to the client with respect to the position. . . . The practitioner also must inform the client of any opportunity to avoid any such penalty by disclosure, if relevant, and of the requirements for adequate disclosure."

Thus, even though OPR may not discipline a practitioner for failure to observe "best practices" or for failure to make sure that a firm's practices are "consistent with the best practices," the standards of the AICPA and even Circular 230 already incorporate some aspects of those best practices. We would suggest that an early task for the tax professional bodies as well as for the advisory committee(s) to be established under section 10.38 of Circular 230 might well be to convene a modern-day Council of Nicaea<sup>2</sup> and see if a uniform code of tax practice standards could be arrived at to serve as a guide for the organizations individually and for the Treasury Department.

### **Enforcement of Standards**

<sup>2</sup> The Council of Nicaea, 325 A.D., was convened by the Emperor Constantine to resolve doctrinal issues within the recently legitimized Christian Church that were threatening the peace of the Roman Empire. The Nicæan Creed is still accepted by the majority of American Christians.

As we have written before,<sup>3</sup> professional tax standards in the past probably have been enforced by malpractice litigation and the threat thereof to a greater extent than by the combined efforts of the professional associations and OPR. That is understandable if the confidential nature of tax return information is considered. The professional bodies themselves do not have subpoena powers and thus cannot instigate effective investigations. The AICPA can censure or expel a member but it cannot order redress to a taxpayer. Taxpayers with complaints that involve pecuniary loss are inclined to take the shortcut and seek redress through the route of a malpractice suit. In those suits, discovery is available, money damages can be obtained, and professional help can be secured on a contingent fee basis.

The ABA has no mechanism for enforcing its standards, the disciplining of attorneys being the province of the highest court in each state. The enrolled agents have no effective mechanism for enforcing their standards either, except to complain to OPR, which in effect is the disciplinary arm of their licensing body. Violations of Circular 230 are handled by OPR administratively, followed by an administrative hearing, with an ultimate appeal to the Secretary of the Treasury and then to a U.S. district court. Thus, a revenue agent with a complaint against a practitioner would lodge it with OPR, while a client who had sustained a loss as a result of bad tax advice or inadequate representation would be inclined to consult an attorney and ultimately file a claim or bring suit.

The result is bias in the system toward malpractice litigation and the threat and fear thereof as the primary enforcer of standards absent vigorous IRS enforcement. Perhaps the new rules in Circular 230 will herald a new day for IRS enforcement of tax practice standards. It will not happen, however, without a concerted effort on the part of OPR, the IRS agents who would rather close a case than push for practitioner penalties, the professional associations that sometimes fear antagonizing their members, and Congress, which trumpets broad enforcement but provides funds for little more than a reactive rather than a proactive approach.

## **Conclusion**

The revisions in Circular 230 are of great importance to the tax practice profession. They mark an official recognition by the IRS that tax practice is conducted by groups and not merely by individuals, and they place responsibility on the leaders of those groups for a system of quality control being in place to review the work done by the group members. We think those revisions could be the first step toward requiring tax practice peer review by outside reviewers -- preferably, we should add, conducted by members of the profession as is peer review of attest function work within the CPA profession and not by an outside governmental body, such as the Public Companies Oversight Board audit practice reviews mandated by the Sarbanes-Oxley Act.

The recitation of best practices is also a change of emphasis, with the IRS starting to recognize the importance of aspirational standards to true professionalism. We would hope that the common interests of the IRS, the AICPA, the ABA, and the NAEA would lead to an attempt to arrive at a basic statement of standards that could be adopted by all those engaged in federal tax practice. IRS adoption is important because the IRS is the ultimate policeman in the tax practice

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See "Tax Practitioner Standards and Professional Self-Discipline," Tax Notes, Oct. 7, 2002, p. 93.

area. Adoption by the professional bodies is likewise important because, we believe, the ideal system involves cooperation in maintaining voluntary quality control systems within practice units, universal peer review of tax practices, and vigorous and sustained action against practitioners who transgress.

Larger practice units face the challenge of evaluating the adequacy of their quality control systems in light of the standards of Circular 230. Smaller practice units may have to face up to the impossibility in many instances of maintaining a system of quality control without the use of outside resources. Cooperation between independent practice units can often solve the problem of how to review one's own work by having independent professionals reviewing each others' work, a practice that many already have incorporated into their systems with increased benefit to both their clients and their own level of comfort with the work they do.

This Circular 230 revision, in other words, could be the start of something big. Now we await the follow-through.