News Analysis: Shelter Penalties: Or Else What? Part 3

by Lee A. Sheppard

In news analysis, Lee Sheppard addresses questions on the final Circular 230 regulations that were raised at the January meeting of the American Bar Association Section of Taxation.

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No sooner did we start waxing sarcastic about Christmas than readers responded with their own complaints.

There was the reader who lives in the New Jersey suburb whose residents got into a knock-down, drag-out fight over the town Christmas display. Was it the now-common legal dispute over the constitutionality of a nativity display? Nope. It was about whether the tree lights should be all white or multicolored. Our reader, who favored white lights, stayed out of it.

Then there was the reader who wondered why his Midwestern in- laws stayed at his house so long. Because they drove to the East Coast from the Midwest, in true Midwestern fashion. Apparently the information that airfares are cheap and highways are dangerous has not made it across the Mississippi. And after an arduous drive, you wouldn't want to leave too soon. We would not want to be the one to have to tell this reader that maybe his mother was right that he shouldn't have married the shiksa. (Go read Phillip Roth instead.)

There is, however, a way for the culturally alienated East Coast denizens to get back at Midwesterners who are testing their sanity. Pretend to embrace the art and culture of the Midwest. (No, not the food; kielbasa will make you fat.) It will drive your in-laws batty.

To that end, we offer rogue taxidermy, courtesy of a three- artist scene from Minneapolis, as an example of avant-garde Midwestern art. Like the Chicago play that was staged in a men's lavatory, rogue taxidermy simultaneously embraces and unwittingly satirizes artistic pretension while managing to offend someone -- in this case, conventional taxidermists. Okay, so Damien Hirst, the British artist famous for the pickled shark, beat them to it. (*The New York Times*, Jan. 3, 2005, p. E1, and www.roguetaxidermy.com.)

Rouge taxidermy involves stitching parts of different animals together in an aesthetic fashion. One artist, a woman, combined cat and eagle parts to make a griffin. A self-taught taxidermist, she also reconstructed P.T. Barnum's infamous hoax "Fiji mermaid" monkey- fish combination and the fish-tailed goat that represents Capricorn. Another artist, a trained taxidermist, only uses roadkill in his art. The third, a vegan from Baltimore, only uses plush toys. The world's largest taxidermy organization, the National Taxidermists Association, denounced the three-member Minnesota Association of Rogue Taxidermists as failing to reproduce wildlife in its natural state.

Plus it's really ugly, so you can torture your Midwestern in- laws with your feigned appreciation of hideous would-be art. "Absurdly gory, sometimes campy" and "aggressively weird," said *The New York Times*. Just imagine the potential of earnestly suggesting to the in-laws that parts of the aging family pets be combined to make a single memorial sculpture of them both.

Of course, some readers think that they have already seen an example of rogue taxidermy in the form of the final Circular 230. Practitioner complaints can be roughly summarized in two sentences. Putting a red herring on everything -- which Circular 230 permits as long as the subject is not a listed transaction -- is anathema because it is really bad public relations. Even if a client is not thinking about penalties, it does not want to be told it cannot rely. And speaking of the client as "it," sophisticated clients that are not natural persons do not want to have to pay for a full-bore covered opinion every time they seek advice in a continuing relationship with their lawyers.

At the American Bar Association Section of Taxation meeting in San Diego on January 22, the authors of Circular 230 showed up at the Standards of Tax Practice Committee to take questions about it. Other officials talked about it at other committees. While their responses were not always responsive, they do shed some light on the application of this regulation to practitioners with business clients. Plus there was a hypothetical that did not involve college savings accounts. This article is in question-and-answer format.

Isn't the final Circular 230 a bit of a bad taxidermy job itself, when applied to business advice?

Deborah Butler, IRS associate chief counsel (procedure and administration), emphasized the consumer protection aspects of the final Circular 230 at the Standards Committee. She defended the required disclaimers.

The IRS, in examinations and litigation, saw tax shelter customers who claimed that no one told them that they could not rely on the marketing opinions they were given, she noted. They said "I didn't understand." So the IRS wants to make advisers tell the clients upfront exactly what they are getting, Butler explained. "Say so upfront, make it explicit, as bright and bold as you can," she summarized the red herring requirement. (All this is on the apparent assumption that the customers will not be able to read the opinions.)

OK, so government has concluded that innocent rich people who don't want to pay tax should be protected from unscrupulous advisers. But sophisticated financial intermediaries do not need to be protected from their lawyers. Indeed, the financial system sometimes needs to be protected from those clients.

Perhaps realizing the incongruity of applying consumer protection rules to financiers, Donald Rocan, IRS deputy chief counsel (operations), told the ABA Tax Section Civil and Criminal Tax Penalties Committee on January 22 that the IRS would use "rules of reason" in applying Circular 230. Government officials recently reaffirmed the common-sense approach at an ABA-sponsored educational session. (For coverage, see *2005 WTD 28-2*.)

What happens if you screw up?

You get fined. You do not get disbarred. Cono Namorato, IRS director of practice, told the ABA Tax Section luncheon on January 22 as much. As the luncheon speaker at the January 25 New York State Bar Association meeting, IRS Commissioner Mark Everson welcomed the enactment of monetary penalties for violations of Circular 230. The clear implication of those statements is that no one ever felt comfortable with the idea of disbarring a practitioner for opining on shelters.

Indeed, the monetary penalties and the new Circular 230 appear to be aimed at the sort of practitioner that the IRS does not need to throw the book at. Steven Whitlock, deputy director of the IRS Office of Professional Responsibility (OPR), told the Standards Committee that the longstanding provisions of Circular 230 "are more than adequate to address some of the more egregious conduct." The IRS has brought cases and is trying to achieve a higher profile for the OPR.

What triggers the opinion standards?

Opinions. Sounds rather obvious, but if the document is not expressing an opinion, it isn't covered. An opinion that is not a "more likely than not" opinion has to be identified as such according to Circular 230 section 10.35(e)(4).

An opinion that is not a covered opinion must nonetheless adhere to standards. Section 10.37 requires that a practitioner giving any kind of opinion must not make unreasonable factual or legal assumptions, unreasonably rely on taxpayer or other representations, fail to consider all of the relevant facts, or base an opinion on the likelihood of audit or settlement. But the practitioner would not be required to describe the facts on which the opinion is based.

Is a memo to the file an opinion? At the Standards Committee, one practitioner asked whether his associates' bad habit of providing oral advice and then writing a memo to the files was producing covered opinions. The answer from the government is no, because a memo to the file isn't furnished to a client. Whitlock noted that despite the problems of proof, oral advice is nonetheless covered by Circular 230.

Is everything a tax shelter?

Everything is a shelter, given the breadth of the definitions of tax avoidance transaction in section 10.35(b)(2)(B) and (C), and "significant federal tax issue" in section 10.35(b)(3). Put it this way: If it isn't a significant federal tax issue that the IRS would care about, why is the client asking for expensive outside legal advice on it?

Well, one practitioner asked, what if the client's taxpayer- sympathetic circuit court approves of a deal, and the other circuits don't? Is that a significant issue? What if the IRS has announced that it disagrees with the sympathetic holding? Butler responded that she would err on the side of finding a significant tax issue.

If the advice is an opinion, does it have to offer penalty protection to invoke the rule?

No. Assuming, in a normal business setting, the adviser is not giving the opinion to third parties to pass around to potential clients, the triggering factor is reliance, as defined by section 10.35(b)(4). Reliance is keyed off giving a more likely than not opinion on a significant federal tax issue.

If a more likely than not opinion is given on the merits, a taxpayer need not be thinking about penalties or specifically relying on the opinion to avoid them, according to Jonathan Ackerman, an attorney-adviser in Treasury's Office of Tax Legislative Counsel who appeared at the Standards Committee on January 22. Even if there is no risk of penalties, Ackerman emphasized, an opinion can be a reliance opinion. "More likely than not" is a 50 percent or greater chance of prevailing, not a 51 percent chance, he emphasized. The wording in Circular 230 itself is not clear, but the preamble says 50 percent chance or better. Follow the preamble on that point, according to Ackerman.

Is every little e-mail an opinion?

You betcha, as your annoying Midwestern in-laws would say. That was confirmed by Brinton Warren, IRS special counsel to the associate chief counsel (procedure and administration), who was one of the drafters of Circular 230. Warren noted that just about every communication that lawyers have with clients takes the form of e- mail, so it cannot be overlooked.

Although a series of e-mails on a continuing discussion of a transaction would seem to form a covered opinion, that is not the way Circular 230 works. What constitutes an opinion is not a question of volume but a question of what is being said, according to Warren. Asked about e-mails, Butler observed that practitioners would not stop giving written advice and go to oral advice, which would not satisfy the client.

Warren focused on the relationship between the client and the adviser. He asked what the purpose of the advice is, and whether it is for penalty protection or not. Practitioners are not going to stop writing advice, and it is important to understand the relationship in analyzing it. Asked whether a practitioner's memo to clients and friends, without marketing by a third party, should trigger the covered opinion rules, he said he would not have a problem as long as everyone understood that reliance was not permitted.

About compliance procedures for firms in section 10.36 of Circular 230, Warren emphasized that the IRS would be reasonable, so as not to impose a regulatory burden. He recognized that procedures that are appropriate for a firm of 200 members might not be appropriate for a firm with 10 members. He noted that although it would be desirable for a firm to have its compliance procedures in writing, Circular 230 does not require that. But there does have to be follow-through on the procedures and oversight within the firm, Whitlock added. Butler interjected that larger firms should have had written compliance procedures in place already under various professional ethical standards.

Ackerman pointed out that Circular 230 requires a disclaimer to differentiate between formal and informal advice. A client needs to know precisely what the advice is and whether to purchase more advice or get a detailed analysis that it can truly rely on. He acknowledged that there would be a learning curve for clients to get used to the new rules. "We don't want clients left in the dark," he said. Circular 230 does not require an engagement letter for each new project in its best practices in section 10.33, but it comes close, as do professional ethical rules.

Well, why can't e-mails back and forth during the development of a transaction be considered preliminary advice?

Section 10.35(b)(2)(ii)(A) defines preliminary advice as "written advice provided to a client during the course of an engagement if a practitioner is reasonably expected to provide subsequent written advice to the client that satisfies the requirements of this section," that is, a covered opinion.

Warren, responding to a question from your correspondent, noted that preliminary advice requires only a reasonable expectation of a fully developed opinion, not the delivery of one. But he said he could not imagine a situation in which parties anticipating a full opinion would not get one.

Ackerman emphasized that preliminary advice, despite the looseness of the definition, is to be narrowly interpreted, so it cannot be a general category for e-mail. Preliminary advice is not required to be labeled as such. Which brings up the question of proof. Your correspondent wonders whether, as a practical matter, it might not be a good idea to label it.

At the Standards Committee, Mark Silverman of Steptoe & Johnson, a corporate transactions specialist, tried to get the officials to say that some informal advice on which the client is intended to rely is not a covered opinion.

Assume a section 355 tax-driven transaction, with written "should" opinions, all in place right before the closing date, Silverman posited. At the 11th hour, either just before or just after the closing, the facts change and change materially. The new facts were not considered in the written opinions. The practitioner who gave the opinions tells the client, via e-mail, that the new facts would have no effect on his prior opinions. Silverman wanted to know whether Circular 230 would oblige the practitioner to go back and redo the opinions, building the answer into a new covered opinion. Would the e-mail have to meet the covered opinion test, or to avoid a redo, carry a disclaimer?

Material changes would seem to require a redo for penalty protection, Warren suggested. Silverman responded that penalties were not an issue (they rarely are in corporate transactional practice). He emphasized that the question is whether the changes in the facts were material to the tax result, and the practitioner's answer was that they were not. Is the practitioner obligated to give a new covered opinion to give that advice?

Warren said that this "never mind" e-mail might be reasonably considered "other written advice" under section 10.37, given the nature of the relationship with the client and the nature of the engagement. "Is it reasonable, based on the information that was given to you by your client, for you to come back with essentially, 'never mind, it's not material'?" he asked rhetorically.

Would it make a difference whether "never mind" came before or after closing? The e-mail sent before closing becomes part of the more elaborate written opinion, as preliminary advice under section 10.35(b)(2)(ii)(A), while the e-mail sent after closing and after the formal opinion was delivered would have to qualify as other written advice under section 10.37.

"Just to be reasonable in interpreting these regulations, on the question posed, clearly it's not a covered opinion when you change a fact," said Whitlock, whose office is charged with enforcing Circular 230. "This would probably fall into section 10.37. A reasonable reading of section 10.37 would cause a reasonable person to conclude that you're OK to say 'go for it.'" Silverman asked for Whitlock's answer in writing, saying that his hypothetical happens all the time.

Can a limited scope opinion refer to other documents?

Usually people who are negotiating a transaction and batting ideas and opinions back and forth with their lawyers have in mind a set of facts that is documented somewhere. Is it acceptable for a limited scope opinion to refer to the known set of facts? Logically, it has to be, given the broad permission in 10.35(c)(3)(v) to assume favorable resolutions of tax issues outside the scope of the opinion, provided that those assumptions are identified.

Can limited scope opinions be written on letterhead?

Section 10.35(b)(8) requires that the disclaimer about a limited scope opinion be in a larger bold typeface than the body of the opinion itself. That means your letterhead is safe for opinions on paper.

How broad is that municipal bond exception?

Section 10.35(b)(9) exempts only an opinion furnished "in connection with the issuance of the bond in a public or private offering." That means that opinions concerning synthetic municipal bonds, created by putting municipal bonds in a partnership or other passthrough entity, are subject to the regular standards for covered opinions, according to Frederick Ballard of Ballard Spahr Andrews & Ingersoll, a municipal bond specialist.

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