Imagine the worst the U.S. Treasury could do to us — they've done it

Revenge of the IRS: Circular 230 changes law practice

By Dan W. Holbrook

Important Notice: Although this written communication may address certain federal tax issues, it does not meet detailed Treasury Department requirements that would allow you to rely on it to avoid tax-related penalties, and you may not do so. If you desire a formal opinion on a particular tax matter for the purpose of avoiding potential imposition of penalties, we will be happy to discuss with you what the Treasury requires, whether it is possible to meet those requirements under the circumstances, and the anticipated time and additional fees involved. No written statement herein relating to any federal tax transaction or matter may be used by any person, without our prior written consent, to support the promotion or marketing of or to recommend any federal tax transaction or matter addressed herein.

This month's column is for all practitioners, not just tax attorneys and estate planners. Imagine the worst the U.S. Treasury could do to us. Well, they've done it. Effective June 21, 2005, amendments to "Circular 230" allow the IRS to disqualify you from practicing before them (including preparing tax returns), fine you, and make your communications to clients valueless to protect them from penalties for relying on your advice, unless you have met extremely detailed and demanding requirements. In terms of practice management, this is one of the most significant events affecting estate planners in the last two decades.

Not just tax lawyers are affected; all attorneys who even incidentally give written advice on federal taxes (divorce, criminal defense, transactional, and title lawyers, beware!) are subject to these new rules. Details of Circular 230 have been well documented in other articles, so the focus here is pragmatic: how to recognize Circular 230 problems in your normal law practice and how to minimize your risk.

Covered opinions – general rule

Under Circular 230, the general rule is that any written advice will be treated as a "covered opinion" if it concerns any significant Federal tax issues and tax avoidance is at least a significant purpose (true in most estate planning). The IRS will determine whether and to what extent tax avoidance is a significant purpose, without giving us any clear advance guidance. "Written advice" includes emails, faxes, even cell phone text messages. Even this column you're reading might be considered "written advice" in certain circumstances. Any time you send anything in writing to your client that mentions any tax effect, the IRS may characterize your writing as a covered opinion.

A "covered opinion" must meet a long list of requirements spelled out in the regulations, and preparing one will entail numerous hours of research and drafting. In essence, the IRS is requiring tax professionals to prepare legal briefs on IRS's behalf as well as the client's. Few clients will agree to pay for that kind of advice. But a covered opinion that fails to meet all those requirements prevents your client from relying on your advice to avoid penalties and may subject you to the draconian penalties described above. Therefore it is important that you not create any covered opinions unless you intend to do so.

Automatic covered opinions — tax avoidance as principal purpose

Certain types of written advice will be extremely difficult not to be characterized as a "covered opinion." Most of these, such as advice on "listed

transactions," marketed opinions, advice subject to conditions of confidentiality, and advice subject to contractual protection, are the province of tax specialists.

Similarly, some written advice is automatically excluded from treatment as a covered opinion, such as SEC filings or advice on a qualified retirement plan, again mostly the province of tax specialists.

In one area, Treasury seems to allow a reasonable exception, then fails to deliver. If tax avoidance is the principal purpose (defined as exceeding any other purpose, whatever that means), as opposed to merely a significant purpose, then the general rule strongly obtains that it will be a covered opinion. In what Treasury no doubt considered a significant concession, it will treat the tax avoidance purpose as only a significant purpose if the arrangement in question "has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose." In other words, if Congress clearly authorizes each and every tax issue in your written advice, then it will not be treated as the principal purpose, even though it clearly results in tax savings.

One would expect this to exempt tax advice on such routine matters as making gifts within the $11,000 annual gift tax exclusion or utilizing all of the federal estate exemption in a "credit shelter trust" at the death of the first spouse. There are two problems. First, how do we know when tax avoidance is or is not the principal purpose? Second, if it is, how do we know whether Treasury will or will not recognize any arrangement as being consistent with Congressional purpose? Most estate planning is about wealth transfer to family, and only secondarily about taxes. But some popular techniques, like GRATs and QPRTs, lend themselves to characterization as having a "principal" purpose of tax reduction, since they would normally have no usage in the absence of the tax benefits. Is it safe to assume that GRATs and QPRTs are consistent with Congressional purposes? Various cases have denied the "routine" annual gift tax exclusion where there were unusual facts. Must you investigate the existence of unusual facts before rendering written advice? Until IRS or the courts provide further guidance on the meaning of "principal purpose" and which techniques are consistent with Congressional purpose, most practitioners should avoid issuing any written advice on tax matters that could be viewed as having tax avoidance as the principal purpose. Yet, of course, we must. For many of us, this part of Circular 230 causes the greatest concern.

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Exceptions — tax avoidance as only a significant purpose

If tax avoidance is a significant purpose, and not the principal purpose, a number of exceptions are available to avoid creating a covered opinion.

(1) No significant federal tax issue. Written advice will not constitute a covered opinion unless there is a significant federal tax issue. A tax issue is "significant" if the IRS has some reasonable basis for a successful challenge. It does not require that the IRS be likely to win, only that it has some reasonable basis for its contrary position. This puts a burden on the practitioner to determine objectively whether there is any authority contrary to the written advice, something most practitioners will rarely be compensated by their clients for doing. Accordingly, practitioners should be wary of relying on this exception to avoid treatment as a covered opinion.

(2) Less than "more likely than not." Written advice will not be a covered opinion if the opinion does not state that the desired tax result is "more likely than not" (MLTN), or words at that confidence level. A MLTN opinion is a "reliance opinion," which will be a covered opinion. It would seem easy enough to avoid MLTN language. Estate planners rarely if ever use that language, preferring terms like "substantial authority" or "reasonable basis," if they qualify the tax discussion at all. Clients, however, are likely to read your tax discussions as MLTN unless you clearly specify otherwise, and so may the IRS. In any event, even without your having used specific MLTN language, your client will likely expect not to be liable for penalties on account of reasonable reliance on your advice if the tax results are not achieved. But your client cannot rely on your advice for penalty protection if you did not add all the requirements of a covered opinion.

(3) Add a legend to a reliance opinion. Written advice that reaches a confidence level of MLTN (a "reliance opinion") will not be a covered opinion if it adds a legend that it cannot be used by the taxpayer to avoid penalties. Despite the potential for poor public relations with clients, this will be the most widely used avenue of avoiding covered opinion status for most written advice by most practitioners. The keys will be educating your clients of the

(Continued on page 30)

(Continued from page 29)

need for such a disclosure and then plastering the required disclaimer on everything you write, including every letter, email, and fax coming out of your office. Here is a suggested disclosure form, which must be "prominently disclosed" in a separate section (not a footnote) in typeface no smaller than other discussion of the law and facts:

This notice is required by Treasury Circular 230: Unless expressly stated herein, nothing contained in this message is intended or written to be used, can be used, or may be relied upon or used, by any taxpayer for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code of 1986, as amended. No one, without our express prior written permission, may use any part of this email in promoting, marketing, or recommending any arrangement relating to any Federal tax matter to one or more taxpayers. Furthermore, it may not be shared with any other person without our prior written consent other than as required by law or by ethical rules. However, this prohibition on sharing this writing does not preclude sharing with others the nature of this transaction or the fact that it may have been consummated.

(4) Not a marketed opinion. Written advice that the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner in promoting, marketing, or recommending an arrangement to one or more taxpayers (a "marketed opinion") will not be a covered opinion if it prominently discloses a disclaimer against such use, such as that displayed under the title of this column.

(5) Limited scope opinion. Among the many requirements for a covered opinion is that the advice must consider ALL significant federal tax issues and must reach a conclusion with respect to each (or state that no conclusion is possible). Even seemingly routine planning can implicate multiple tax issues. The sheer number of these in any particular transaction may cause practitioners to overlook or ignore any number of what the IRS may deem to be significant federal tax issues. A practitioner may instead prepare a "limited scope opinion." It relieves the practitioner from the burden of identifying and addressing all such issues by allowing the areas of discussion to be narrowed to those most relevant to the client. Note, however, that a limited scope opinion is still a covered opinion with respect to the issues discussed and must meet all the requirements for a covered opinion to the extent of the limited scope.

New rules for all other written advice

Even if written advice is not a covered opinion, additional new rules apply, the violation of which can subject a practitioner to the same penalties discussed above. In summary, written advice cannot be based on unreasonable factual or legal assumptions, fail to consider all relevant facts, or take into account the possibilities that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled if raised. Do not discuss audit and settlement possibilities in writing. Period.

Summary

The Treasury has overreacted in its attempt to police tax collections by treating tax professionals as presumptive criminals. Circular 230 will drive a wedge between taxpayer and professional advisor. It will encourage professionals to give only oral advice, unsupported by writing, except perhaps internal memoranda. It will encourage IRS examiners to use intimidation tactics on tax professionals. Worst of all, it will encourage taxpayers to seek tax advice where the cost is lower, such as insurance salesmen and stockbrokers, possibly resulting in more flawed or aggressive tax reporting rather than less. It may even be unconstitutional as a violation of the First Amendment right of free speech. But it is the law — for now. These are interesting times for estate planners.

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