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April 6, 2005

Mr. Eric Solomon  
Acting Deputy Assistant Secretary (Tax Policy)  
Department of the Treasury  
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The Honorable Mark W. Everson  
Commissioner  
Internal Revenue Service  
Room 3000 IR  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

Dear Acting Assistant Secretary Solomon and Commissioner Everson:

I am pleased to submit the comments of the American College of Trust and Estate Counsel ("ACTEC") with respect to the amendments to regulations governing practice before the Internal Revenue Service that were published in December of last year (the "New Regulations"). ACTEC is a professional association consisting of approximately 2,600 lawyers who are selected on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching and bar activities.

The New Regulations are intended to strengthen the Treasury Department's attack on abusive tax shelters and promote public confidence in tax professionals. We support these goals and believe that the New Regulations, to the extent they are addressed to the purveyors and purchasers of abusive tax shelters, are entirely appropriate.

However, we believe that the New Regulations in their current form will inhibit the flow of many types of written advice between taxpayers and tax professionals, with the result that tax compliance is likely to suffer. We think

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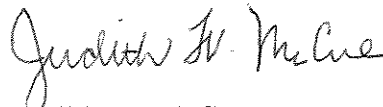
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that the recommendations contained in our comments will enable the Treasury Department to achieve its goals without staunching the free flow of tax advice.

We appreciate your consideration of our recommendations and would welcome the opportunity to discuss them further with you. If you would like to discuss our recommendations or any aspect of the New Regulations, please contact Carlyn McCaffrey, who chaired the ACTEC Task Force that drafted the comments. Mrs. McCaffrey's address is Weil, Gotshal & Manges, LLP, 767 Fifth Avenue, New York, New York 10153 and her telephone number is 212-310-8136.

Respectfully submitted,



Judith W. McCue  
President

cc: Helen M. Hubbard, Tax Legislative Counsel, Department of the Treasury  
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# AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL

## COMMENTS ON CIRCULAR 230 REGULATIONS\*

April 6, 2005

### *I. Introduction and Summary of Recommendations*

On December 20, 2004 the U.S. Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) published sweeping revisions to the Circular 230 regulations that establish standards of practice for tax professionals who practice before the Service (the “New Regulations”).<sup>1</sup> The New Regulations, which, for the most part, become effective on June 20, 2005, impose heavy burdens on those who give written tax advice to clients. Tax practitioners who violate the new rules face the threat of censure, suspension, or disbarment from practice before the Service.<sup>2</sup> If the new rules become effective in their present form, they will cause a major change in the practice of tax law by requiring most written tax advice to comply with the standards normally applicable to formal opinions of law.

The New Regulations reach far more deeply into the day to day practice of tax law than did the proposed regulations issued on December 30, 2003 (the “Proposed Regulations”)<sup>3</sup> without giving members of the tax bar an opportunity to present their views as to how the deeper reach would affect their practices and the administration of the tax laws. The scope of the Proposed Regulations was limited to marketed and “more

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\* The American College of Trust and Estate Counsel (“ACTEC”) is a professional association consisting of approximately 2,600 lawyers who are selected on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching, and bar activities. These comments were prepared by the ACTEC Task Force on Circular 230, composed of members of ACTEC’s Business Planning, Estate and Gift Tax, Fiduciary Income Tax, and Professional Responsibility Committees. The individual members of the Task Force are Ronald D. Aucutt, Jonathan G. Blattmachr, W. Birch Douglass, III, Christopher H. Gadsden, Ellen K. Harrison, Linda B. Hirschson, Edward F. Koren, and Carlyn S. McCaffrey. Helpful comments were received from Dennis I. Belcher, T. Randolph Harris, and Judith W. McCue. The Tax Force thanks Amy E. Heller for her valuable assistance in coordinating the preparation of these comments.

<sup>1</sup> 31 CFR part 10, reprinted as Treasury Department Circular 230.

<sup>2</sup> The American Jobs Creation Act of 2004 (P.L. 108-357) (the “Jobs Act”) also authorizes Treasury and the Service to impose a monetary penalty against practitioners who violate any provision of Circular 230. The New Regulations do not reflect this authorization.

<sup>3</sup> Reg-122379-02, 68 F.R. 75186.

likely than not” tax shelter opinions. The New Regulations expand the reach of Circular 230 to include, among other advice, all written tax advice that concerns a transaction a principal purpose of which is the avoidance of any Federal tax regardless of the level of confidence reached (even those that conclude that a proposed transaction would not be effective to reduce taxes) and regardless of whether the transaction involves the use of tax benefits that Congress intended taxpayers to have.

The New Regulations are part of the attack by Treasury and the Service against abusive tax shelters. Their goal is to enhance tax compliance by promoting public confidence in tax practitioners. The New Regulations will make it more difficult for the marketers of such shelters to obtain opinions that can be used in connection with their marketing efforts and more costly for taxpayers who wish to engage in such transactions to obtain opinions that can be relied upon to avoid penalties. We support this attack and believe that the New Regulations, to the extent they are addressed to the purveyors and purchasers of abusive tax shelters, are entirely appropriate.

We believe, however, that Treasury and the Service have cast the net of the New Regulations too wide. As a result, the New Regulations will inhibit the flow of many types of tax advice between tax practitioners and their clients, from major corporations seeking sophisticated advice to individuals seeking advice related to ordinary personal transactions such as the structuring and acceptance of deferred compensation arrangements, marriage and divorce, and the transmission of assets to family members during life and at death. The greater cost of furnishing written tax advice will cause taxpayers to increasingly rely on oral advice, or advice from those who do not practice before the Service, which is necessarily less thorough and less precise, with the result that tax compliance is likely to suffer.<sup>4</sup>

The New Regulations have created a high level of anxiety among all tax practitioners. Treasury officials have reacted to these concerns by encouraging tax practitioners “to submit detailed comments that would help identify advice that shouldn’t be subject to burdensome restrictions.”<sup>5</sup> This report sets forth the response of the American College of Trust and Estate Counsel to Treasury’s requests for comments. We believe it is possible to amend the New Regulations to facilitate the delivery of

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<sup>4</sup> As James M. Peaslee suggested in his letter to the Service dated March 7, 2005 and published in the March 9, 2005 issue of Tax Notes Today, if the New Regulations intrude into the relationship between an attorney and his or her client or interfere with the legitimate expression of opinion as to the interpretation of the tax law to a degree that is more than is necessary to achieve legitimate tax enforcement goals, First Amendment issues may be raised. ATTORNEY SEEKS IMPROVEMENTS TO CIRCULAR 230 RULES, Tax Notes Today (March 9, 2005).

<sup>5</sup> GOVERNMENT URGES COMMON-SENSE APPROACH TO CIRCULAR 230 REGS., Tax Notes Today (February 10, 2005), describing remarks made by Eric Solomon, Deputy Assistant Secretary for Tax Policy, during a February 9, 2005 ABA-CLE Teleconference.

legitimate tax advice without compromising Treasury's and the Service's attempts to curb the proliferation of abusive tax shelters.

As a preliminary matter, we believe that Treasury and the Service should promptly announce that they are postponing the effective date of the New Regulations while they consider the comments that they receive. Practitioners should not be forced to incur the significant expense of preparing for the effective date if the rules are likely to change in response to comments.

Our recommendations are summarized immediately below and are explained in more detail in section III of these comments. Items A through D below contain our recommendations for crafting a more workable definition of "covered opinion," the term used in the New Regulations to identify the kinds of written advice required to comply with standards normally applicable to formal opinions of law. Items E through H contain our recommendations concerning the rules applicable to covered opinions.<sup>6</sup>

#### ***A. Clarify and Limit the Definition of Covered Opinion***

The New Regulations should provide a clear definition of a covered opinion. The definition should be (a) broad enough to reach favorable written advice relating to those transactions that are of particular concern to the Service without reaching the countless tax savings devices that are not of particular concern and (b) objective enough to enable a practitioner to determine easily whether any particular written tax advice is a covered opinion.

We believe these objectives would be achieved if the definition of covered opinion were limited to marketed opinions, written advice concerning reportable transactions which have a significant purpose of avoiding Federal income tax ("Significant Purpose Reportable Transactions") and listed transactions. We use the terms "listed transactions" and "reportable transactions" as they are used in Section 6662A.<sup>7</sup>

If Treasury and the Service believe that this definition of covered opinion is too narrow, we believe it would be reasonable to add tax shelters as described in Section 6662(d) and as defined more fully in Treasury Regulations Section 1.6662-4(g)(2). Although the addition of this category of transactions would create more uncertainty, the

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<sup>6</sup> See, generally, Jonathan G. Blattmachr, Mitchell M. Gans, Tracy L. Bentley, THE APPLICATION OF CIRCULAR 230 IN ESTATE PLANNING (THIS ARTICLE MAY NOT BE RELIED UPON FOR PENALTY PROTECTION), Tax Notes (April 4, 2005), recommending certain changes to the New Regulations, some of which are similar to the recommendations made herein.

<sup>7</sup> References to Sections are to sections of the Internal Revenue Code of 1986 (the "Code"), as amended, if preceded by "Treasury Regulations," to sections of the Treasury Regulations under the Code, or, if preceded by "Circular," to sections of the New Regulations.

regulations do provide significant guidance that can be used in determining whether a particular transaction is a tax shelter.<sup>8</sup>

***B. Eliminate the Distinction Between Principal Purpose and Significant Purpose Transactions***

If the recommendations set forth in paragraph A are not acceptable, we suggest the removal of the distinction between transactions the principal purpose of which is tax avoidance and transactions a significant purpose of which is tax avoidance (“Principal Purpose Transactions” and “Significant Purpose Transactions,” respectively).

***C. Exclude Written Advice That Concludes There Is Not a Reasonable Basis for Tax Treatment Favorable to the Taxpayer***

Whatever definition of covered opinion is adopted, we believe that the definition of covered opinion should exclude written advice that concludes there is not at least a reasonable basis for the tax treatment the taxpayer seeks to achieve in connection with a particular transaction. Clearly it is in the government’s best interest to allow a practitioner to concisely advise a client that a proposed transaction is not effective to avoid tax.

***D. Clarify the Definition of Marketed Opinion***

The regulations should clarify and refocus the definition of “marketed opinion” so that the emphasis is less on the possible use of the opinion by a person other than the practitioner’s client and more on its use to sell a transaction having a significant purpose of avoiding taxes.

***E. Extend the Covered Opinion Standards Now Applicable to Significant Purpose Transactions to all Covered Opinions***

Whatever definition of covered opinion is adopted, the requirements now applicable to “reliance opinions” written in connection with Significant Purpose Transactions should apply to all covered opinions. That is, practitioners should be able to elect out of the covered opinion requirements for any particular writing by including in that writing a prominent disclosure that the writing cannot be used for the purpose of penalty protection and should be able to give limited scope opinions with respect to any type of transaction.

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<sup>8</sup> We note, however, that the changes to Section 6662(d)(2)(C) made by the Jobs Act eliminated the statutory exception to the understatement penalty for participants in tax shelters who reasonably believed that their positions were more likely than not the proper treatment.

***F. Moderate the Type of Disclosure Required to Elect Out of Covered Opinion Treatment***

The disclosure requirements of Circular Sections 10.35(b)(2)(ii) and (b)(8), which enable practitioners to elect out of the rules governing covered opinions in certain circumstances, should be modified so that they are less disruptive to the attorney-client relationship and more practical in view of modern methods of attorney-client communication.

***G. Modify the Disclosure Requirements Applicable to Opinions Concerning a Significant Tax Issue When a More Likely Than Not Conclusion Is Not Necessary to Avoid Penalties***

If the term covered opinion is ultimately defined to include written advice concerning transactions for which a “more likely than not” opinion is not required to avoid penalties (as is the case based on the definition of covered opinion currently in the New Regulations), the disclosure requirement of Circular Section 10.35(e)(4) should be modified. Specifically, the disclosure requirement should be adjusted to enable clients to rely on opinions failing to reach a “more likely than not” conclusion in situations where the Code does not in fact require a more likely than not conclusion to avoid penalties.

***H. Clarify the Rules Limiting a Practitioner’s Ability to Discuss Audit Risks With Clients***

The regulations should make it clear that a tax practitioner may provide clients with written advice concerning 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 provided that the conclusions he or she reaches as to any significant Federal tax issue on the merits are not based in whole or in part on any such possibility.

***II. Description of the New Regulations’ Requirements for Written Advice Constituting a Covered Opinion***

***A. In General***

Circular Section 10.35 is the heart of the New Regulations. It requires any written advice concerning one or more Federal tax issues constituting a covered opinion to comply with a set of standards similar to those that many tax practitioners would follow if they were delivering formal opinions. Practitioners would not be likely to comply with these standards if they were delivering informal tax advice in letter, memorandum or e-mail form. This is particularly so if the communication merely describes the expected tax consequences of common documents, arrangements, and transactions such as wills, trust agreements, partnership and limited liability agreements, and prenuptial and marital settlement agreements. Even when practitioners usually would follow standards similar to those set forth in Circular Section 10.35, their standards almost certainly would vary to some extent from those set forth in the section.

## ***B. Covered Opinion***

A covered opinion is any written advice (including e-mails) concerning one or more Federal tax issues arising from:<sup>9</sup>

1. A listed transaction under Treasury Regulations Section 1.6011-4(b)(2) or a transaction the same as or substantially similar to a listed transaction.
2. An entity, plan or arrangement that has a principal purpose of avoiding or evading any tax imposed by the Code (a “Principal Purpose Transaction”).
3. An entity, plan or arrangement that has a significant purpose of avoiding or evading any tax imposed by the Code (a “Significant Purpose Transaction”) but only if the written advice is:
  - a. a reliance opinion;
  - b. a marketed opinion;
  - c. subject to conditions of confidentiality; or
  - d. subject to contractual protection.

The New Regulations do not provide any guidance for determining whether an entity, plan, or arrangement has a principal or significant purpose of avoiding a tax imposed by the Code. Nor do they provide any exception for Principal Purpose Transactions or Significant Purpose Transactions that rely on exclusions, deductions or other tax benefits clearly provided by the Code, including, for example, the exclusions from gross income provided by Sections 101, 102, and 103.

A Federal tax issue is any issue that concerns the Federal tax 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.<sup>10</sup>

A reliance opinion is written advice concerning a Significant Purpose Transaction that concludes there is a greater than 50 percent likelihood that a significant Federal tax issue would be resolved in the taxpayer’s favor unless the written advice prominently discloses that it cannot be used by the taxpayer for the purpose of avoiding penalties. For

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<sup>9</sup> A particular writing may fall into more than one category of covered opinion.

<sup>10</sup> This definition of “Federal tax issue” apparently excludes issues relating to various Federal taxes such as employment taxes and certain Federal excise taxes that are imposed without reference to 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.

this purpose, a significant Federal tax issue is any issue as to which the Service has a reasonable basis to challenge a resolution favorable to the taxpayer who is receiving the written advice if the resolution could have a significant impact on the overall Federal tax treatment of the transaction discussed in the written advice. In order to satisfy the prominent disclosure requirement, as it applies to reliance opinions and marketed opinions, the disclosure must appear in a separate section at the beginning of the written advice and must be in bold typeface that is larger than any other typeface used in the written advice. If the written advice merely concludes that there is a reasonable basis that a significant Federal tax issue would be resolved in the taxpayer's favor, the advice is not a covered opinion. Nevertheless, the written advice must prominently disclose that it cannot be relied upon for penalty protection even if a taxpayer who engages in the transaction discussed in the writing does not need a more likely than not opinion to avoid penalties.

A marketed opinion is written advice concerning a Significant Purpose Transaction that the practitioner knows or has reason to know will be used by a person other than the practitioner or a person associated with her firm in promoting, marketing or recommending an entity, plan or arrangement to one or more taxpayers unless the advice prominently discloses that it cannot be used by the taxpayer for the purpose of avoiding penalties, that it was written to support the marketing of the transaction described, and that the taxpayer should seek tax advice from an independent tax advisor.<sup>11</sup> The prominent disclosure exception does not apply to advice that relates to a listed transaction or a Principal Purpose Transaction. As a result, any written advice with respect to a listed transaction or Principal Purpose Transaction will be a marketed opinion if the practitioner delivering the advice knows or has reason to know it will be used by a person other than the practitioner or a person associated with her firm in recommending an entity, plan or arrangement to one or more taxpayers.

Written advice concerning a Significant Purpose Transaction is subject to conditions of confidentiality if the practitioner providing the advice imposes on one or more recipients a limitation on disclosure of the tax treatment or structure of the transaction, and the limitation protects the confidentiality of that practitioner's tax strategies.

Written advice concerning a Significant Purpose Transaction is subject to contractual protection if the practitioner (or a person associated with her firm) is obligated to fully or partially refund fees if the intended tax results are not sustained or if the collection of fees is contingent on the taxpayer's enjoying the predicted tax benefits from the transaction.

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<sup>11</sup> Curiously, the New Regulations require that the prominent disclosure state that the advice was written to support the "promotion or marketing" of the transaction even if the advice was written merely to recommend a particular transaction to a client and members of that client's family.

### *C. Requirements for Covered Opinions*

The New Regulations specify four requirements with which a covered opinion must comply. Each requirement has subparts. Other rules are specified as well. Realistically, the practitioner will have to deal with a dozen or so requirements for most covered opinions.

1. Factual Matters. A practitioner must use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and to determine which of the facts are relevant. The practitioner must not base the opinion on any unreasonable factual assumption (including any assumptions with respect to future events). An unreasonable factual assumption is one that the practitioner knows or should know is incorrect or incomplete. Similarly, the practitioner may not rely on any unreasonable factual representations, statements or findings of the taxpayer or any other person. Apparently, whether the practitioner did or did not use reasonable efforts is an objective standard but the scope of the required efforts a practitioner must make to ascertain the facts is unclear. In other words, the fact that the practitioner honestly, and perhaps even reasonably, believed she had made reasonable efforts to identify and ascertain the facts may not be found to be compliance if it turns out the efforts were not reasonable. For example, if a client asks for advice as to the gift tax consequences of a gift to her husband, may the practitioner rely on the client's representation that her husband is a United States citizen or must she request a copy of his passport?<sup>12</sup> If the gift is to take place in the future, what steps is she required to take to determine if he plans to relinquish his United States citizenship? Must the practitioner determine whether the husband has agreed to provide consideration for the transfer, such as a promise to make a gift to a third party? As another example, does a practitioner who is providing written advice as to the generation-skipping transfer tax consequences of a client's gift to an unrelated person have the responsibility of independently verifying the age of the donee?<sup>13</sup>

2. Relate Law to Facts. The practitioner, in rendering a covered opinion, must relate the applicable law to the facts. Applicable law includes "potentially applicable judicial doctrines." Although not specified, these may include the substance over form doctrine, the business purpose doctrine, the economic substance doctrine, the step transaction doctrine, and the reciprocal trust or reciprocal transfer doctrines.

The practitioner cannot assume any favorable resolution of any significant federal tax issue except (i) with respect to certain "limited scope opinions" and (ii) in those circumstances where the practitioner is permitted to and does rely on the opinion of another practitioner, who is competent to give such advice. Apparently, the practitioner

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<sup>12</sup> Gifts to spouses who are not United States citizens are not eligible for the gift tax marital deduction. Section 2523(i).

<sup>13</sup> Gifts to unrelated individuals who are more than 37 1/2 years younger than the donee may be subject to the generation-skipping transfer tax. Sections 2612(c) and 2651(d).

may assume favorable resolution of any Federal tax issue that is not significant (that is, the Service has no reasonable basis for a successful challenge or the resolution of the challenge could not have a significant impact on the overall Federal tax treatment of the transactions or matters addressed in the opinion). For example, a practitioner who is providing written advice as to the gift tax consequences of a proposed gift of a patent to a spouse could perhaps assume that the Service would have no reasonable basis for challenging the gift tax marital deduction by claiming that a patent, which has a limited economic life, is a nondeductible terminable interest within the meaning of Section 2523(b).

The opinion must not contain internally inconsistent legal analyses or conclusions. For example, a conclusion that the actuarial value of the remainder interest in a charitable remainder trust was less than ten percent is inconsistent with a conclusion that the value of the remainder is deductible for income and gift tax purposes.<sup>14</sup> It is not necessary that the inconsistency relate solely to Federal tax issues. For example, a conclusion that a donor's husband is not a citizen of the United States would be inconsistent with a conclusion that a gift to the husband qualifies for the marital deduction even though the former conclusion is not one that directly involves a tax issue.<sup>15</sup>

3. Evaluation of Significant Federal Tax Issues. A covered opinion must consider all significant federal tax issues and analyze the likelihood that the taxpayer will prevail on the merits with respect to each such issue. (As described above, exceptions to this requirement exist for limited scope opinions and in circumstances where the practitioner relies on the opinion of another practitioner.) Written advice may constitute a covered opinion and, therefore, be required to comply with these evaluation rules, even though it does not discuss any significant Federal tax issue.

4. Overall Conclusion. The opinion must provide the practitioner's overall conclusion as to the likelihood that the Federal tax treatment of the arrangement is the proper treatment and the reasons for that conclusion.

In the case of a marketed opinion, the opinion must provide the practitioner's overall conclusion at a confidence level of at least more likely than not. If the practitioner cannot reach that level of confidence with respect to a marketed opinion, the opinion may not be issued without violating the New Regulations. In this regard, the New Regulations appear to make an important distinction between marketed opinions and other covered opinions.

In the case of other opinions, if the practitioner cannot reach a confidence level of at least more likely than not, the written advice must prominently disclose, among other

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<sup>14</sup> In order to constitute a qualified charitable remainder trust under Section 664, the actuarial value of the remainder must be at least ten percent. Section 664(d)(2)(D).

<sup>15</sup> See Section 2523(i).

required disclosures, that the client may not use the advice for the purpose of avoiding penalties. This rule is applicable whether or not the type of transaction discussed requires a more likely than not level of confidence in order for the taxpayer to avoid penalties.

### ***III. Explanation of Recommendations***

#### ***A. Clarify and Limit the Definition of Covered Opinion***

The New Regulations should provide a clear definition of a covered opinion. The definition should be (a) broad enough to reach favorable written advice relating to those transactions that are of particular concern to the Service without reaching the countless tax savings devices that are not of particular concern and (b) objective enough to enable a practitioner to determine easily whether any particular written tax advice is a covered opinion.

The New Regulations identify as covered opinions written advice concerning listed transactions and advice subject to conditions of confidentiality or contractual protection. These categories of covered opinions are clear, in part because they are easily identifiable and in part because they are the subject of other guidance.<sup>16</sup> The New Regulations less clearly identify other written advice falling within the definition of covered opinion. This lack of clarity is a problem for tax practitioners, who in many cases serve as enforcers of our tax system.

We believe that the goals of breadth and objectivity described above can be achieved if the definition of covered opinion is coordinated with those areas where Congress and the Service have indicated that taxpayers will be subject to elevated scrutiny. Under current law, taxpayers are subject to heightened scrutiny with respect to their participation in transactions identified in the Treasury Regulations under Section 6011 (“Reportable Transactions”). Reportable Transactions include listed transactions, confidential transactions, transactions with contractual protection, loss transactions, transactions with a significant book-tax difference, and transactions involving a brief asset holding period. Taxpayers must disclose Reportable Transactions on Form 8886 in order to avoid monetary penalties imposed by Section 6707A. Of course, not all Reportable Transactions have tax avoidance as a purpose, a fact reflected in the new penalty provisions of the Jobs Act.<sup>17</sup> New Section 6662A, which is aimed at “combating abusive tax avoidance transactions,”<sup>18</sup> imposes an accuracy-related penalty on listed

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<sup>16</sup> See Treasury Regulations Section 1.6011-4.

<sup>17</sup> For example, an offering memorandum for interests in an operating or investment partnership will customarily contain a summary of the tax considerations relevant to a purchase of the partnership interests. Offering memoranda are frequently marked “confidential,” not because of any tax strategies that the partnership will pursue, but simply to protect the partnership’s operational and investment strategies.

<sup>18</sup> H.R. Rep. 108-548, pt. 1.

transactions and on other Reportable Transactions that have a significant purpose of avoiding Federal income tax (referred to in these comments as “Significant Purpose Reportable Transactions”). New Section 6664(d) also contains special rules for transactions falling into these categories.

We believe that the transactions described in Section 6662A provide a good basis for identifying the types of written advice that should be subject to heightened covered opinion standards under the New Regulations. Accordingly, we recommend that the New Regulations treat written advice as a covered opinion if the advice (i) concerns a listed transaction, (ii) concerns a Significant Purpose Reportable Transaction or (iii) is a marketed opinion (as discussed separately in section III.D. of these comments, below).

This definition will reach written advice relating to transactions of particular concern to Congress and the Service and will also promote the goals of a unified enforcement policy and simplification of the tax laws. The Service’s efforts to stem abuses by subjecting tax practitioners to elevated standards with respect to their preparation of certain written advice will be coordinated with efforts to stem abuses by subjecting taxpayers to elevated standards with respect to their participation in certain transactions. Our proposed definition also will enable the New Regulations to benefit from the interpretive guidance that has been and will be issued by Treasury to help taxpayers comply with their obligations in respect of Reportable Transactions.<sup>19</sup>

We stated above that the definition of covered opinion should be sufficiently objective to permit practitioners to easily determine whether a particular piece of written tax advice constitutes a covered opinion. Our proposed definition of covered opinion will in fact require practitioners to make a subjective determination as to whether a Reportable Transaction has tax avoidance as a significant purpose. But, this is a level of uncertainty that practitioners will need to learn to deal with in connection with the possible application of Section 6662A to their clients’ transactions. Ideally, Treasury will issue further guidance, perhaps similar to that provided in Treasury Regulations Section 1.6662-4(g)(2), to help practitioners determine what aspects of a transaction are to be put to this subjective significant purpose test – *i.e.*, the structure of a transaction or its overall objective.<sup>20</sup> However, whether or not such further guidance is issued, our

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<sup>19</sup> See, for example, Revenue Procedure 2003-25, which provides a list of book-tax differences that are not to be taken into account in determining whether a transaction is reportable under Treasury Regulations Section 1.6011-4.

<sup>20</sup> For example, under the New Regulations, is the creation of a charitable remainder trust for the benefit of the donor and charity a Principal Purpose Transaction or a Significant Purpose Transaction? If the proper focus of the inquiry is on the structure, arguably it is a Principal Purpose Transaction or at least a Significant Purpose Transaction. Few donors would choose to establish this highly restrictive form of trust if it did not offer significant income tax savings. On the other hand, if the proper focus of the inquiry is on the ultimate objective, to give property to charity, the creation of a charitable remainder trust should be neither a Principal Purpose Transaction nor a

proposed definition of covered opinion will require practitioners to make a subjective determination as to a client's purpose only in respect of those transactions that fall within one of the relatively objective categories of the Treasury Regulations under Section 6011. In contrast, the New Regulations in their current form would force practitioners to identify and weigh their clients' motives prior to rendering written advice on almost any tax-related question.<sup>21</sup>

The portion of our proposed definition of covered opinion relating to Significant Purpose Reportable Transactions is limited to transactions that affect Federal income tax liability. That is, this portion of the definition does not encompass transactions involving other taxes, such as estate, gift, employment or excise tax. This result flows from the fact that, other than with respect to listed transactions, the Reportable Transaction rules under Section 6011 and the accuracy-related penalty rules of Section 6662A are themselves limited to transactions that affect Federal income tax.

We believe that limiting the definition of covered opinion in a manner that is consistent with these Sections makes good sense. A significant goal of the New Regulations is the protection of taxpayers who rely on written advice to avoid penalties.<sup>22</sup> Accordingly, as currently drafted, the New Regulations provide that an opinion failing to reach a more likely than not conclusion must prominently disclose that it cannot be used for the purpose of avoiding penalties.<sup>23</sup> The more likely than not standard, however, is relevant under current law only to understatements of Federal income tax.<sup>24</sup> Penalties

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#### Significant Purpose Transaction.

<sup>21</sup> For example, under the New Regulations as currently drafted, before responding to a client's e-mail inquiring "whether I can give my granddaughter a \$10,000 gift and have it be covered by my annual gift tax exclusion," a practitioner would need to ascertain whether the client's question was motivated by a desire to make a gift to his granddaughter, with any tax considerations only secondary, or whether a significant purpose or the principal purpose of the client's gift was to transfer assets free of gift, estate or generation skipping transfer tax.

<sup>22</sup> SHELTER PENALTIES: OR ELSE WHAT? PART 3, Tax Notes Today (February 14, 2005), describing remarks made by Deborah Butler, IRS Associate Chief Counsel, during a January 22, 2005 ABA Tax Section meeting.

<sup>23</sup> Section 10.35(e)(4) of the New Regulations.

<sup>24</sup> Section 6664(d). Prior to amendment by the Jobs Act, Section 6662(d) provided that the amount of a taxpayer's understatement of income tax could, in the case of a "tax shelter" (defined in Section 6662(d)(2)(C) as a plan or arrangement a significant purpose of which is the avoidance or evasion of Federal income tax), be reduced if there was "substantial authority" for the taxpayer's treatment, and the taxpayer "reasonably believed" that the treatment was "more likely than not" the proper treatment. Under Treasury Regulations Section 1.6662-(4)(g)(4)(i), a taxpayer may reasonably believe that the tax treatment of an item is more likely than not proper if the taxpayer relied in good

related to other taxes can generally be avoided based on less stringent standards.<sup>25</sup> Accordingly, we believe that it is appropriate that the definition of covered opinion be more expansive with respect to transactions affecting income tax liability.

The portions of our proposed definition of covered opinion concerning marketed opinions and listed transactions are not limited to transactions affecting Federal income tax liability. Marketed opinions are discussed in subsection D of this section III. Written advice can be a marketed opinion regardless of the type of Federal tax involved in the transaction discussed in the advice. We have recommended retaining marketed opinions within the definition of covered opinion because of the historical role such opinions have played in the propagation of abusive shelters.

Listed transactions involving estate tax, gift tax, employment tax, and certain excise taxes will fall within our proposed definition of “covered opinion,” when the Service adds such transactions to the list of transactions issued under Treasury Regulations Section 1.6011-4(b)(2) because listed transactions involving these taxes have been identified as Reportable Transactions that are subject to the disclosure rules of Section 6011 and the accuracy-related penalty rules of Section 6662A.<sup>26</sup> We have recommended retaining advice concerning listed transactions within the definition of covered opinion because the transactions so listed are of particular concern to the Service.

If Treasury and the Service conclude that our proposed definition of covered opinion is too narrow, we think it would be reasonable to add tax shelters as described in Section 6662(d) and as defined more fully in Treasury Regulations Section 1.6662-

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faith on the opinion of a professional tax adviser, the adviser’s opinion was based on an analysis of the pertinent facts and authorities, and the adviser concluded that there was a more than 50-percent likelihood that the tax treatment of the item would be upheld if challenged by the Service.

Following the Jobs Act, a taxpayer can avoid substantial understatement penalties attributable to a tax shelter if she meets the “reasonable cause” exception of Section 6664(c). (The reasonable cause exception of Section 6664(c) makes no reference to a more likely than not standard, although possibly a more likely than not opinion would be able to help establish reasonable cause.) In the case of “reportable transaction understatements,” which, pursuant to new Section 6662A are understatements of taxable income attributable to Significant Purpose Reportable Transactions, a taxpayer can avoid penalties if, among other requirements, she establishes that she reasonably believed that her chosen tax treatment was more likely than not the proper treatment.

<sup>25</sup> For example, underpayments attributable to negligence or disregard of rules or regulations can be avoided based on a “reasonable basis” standard. See Section 6662(b)(1) and Treasury Regulations Section 1.6662-3(b)(3).

<sup>26</sup> See Treasury Regulations Sections 20.6011-4, 20.6011-5, 31.6011-4, 53.6011-4, 54.6011-4, and 56.6011-4.

4(g)(2). As described above, the drafters of the New Regulations appear to be concerned with ensuring that clients who need to be able to show reliance on “more likely than not” opinions issued by tax advisors to avoid the substantial understatement of income tax penalties of Section 6662 with respect to tax shelters will not mistakenly rely on written advice that does not meet the requirements of Treasury Regulations Section 1.6662-4(g)(4)(i)(B). Although inclusion of advice with respect to tax shelters would introduce additional uncertainty into the definition of covered opinion by requiring practitioners to determine whether particular transactions satisfy the subjective standards of the definition of tax shelter, the regulations provide guidance that could be used in making this determination.

***B. Eliminate the Distinction Between Principal Purpose and Significant Purpose Transactions***

Under the New Regulations, a covered opinion includes written advice with respect to all Principal Purpose Transactions. In contrast, it includes Significant Purpose Transactions only if the written advice is a reliance opinion, a marketed opinion, is subject to conditions of confidentiality or is subject to contractual protection.

If the definition of covered opinion proposed in subsection A of this section III is not acceptable, we suggest the modification of the definition to eliminate the distinction between Principal Purpose Transactions and Significant Purpose Transactions and that all written advice with respect to Principal Purpose Transactions be subject to the same criteria now used for determining whether written advice regarding a Significant Purpose Transaction constitutes a covered opinion.

The treatment of written advice under the New Regulations is substantially different depending upon whether tax avoidance constitutes a principal purpose rather than a significant purpose of a transaction. Any written advice concerning one or more Federal tax issues arising from a Principal Purpose Transaction is automatically subject to the covered opinion requirements. There is no opportunity to elect out of the requirements. Written advice with respect to a Significant Purpose Transaction, however, will not constitute a covered opinion if it includes a prominent disclosure that it is not to be relied upon for penalty protection. Furthermore, such written advice will not constitute a covered opinion unless it “concludes at a confidence level of at least more likely than not that one or more significant Federal tax issues will be decided in the taxpayer’s favor.” Unlike written opinions with respect to Principal Purpose Transactions, a practitioner can elect out of covered opinion status for advice concerning Significant Purpose Transactions by making the requisite disclosures.

Despite this substantial difference in treatment, the distinction between a Principal Purpose Transaction and a Significant Purpose Transaction is far from clear. In many instances, it will be difficult for a practitioner to determine into which of the two categories a particular transaction fits. And yet, if the practitioner erroneously determines that a particular arrangement constitutes a Significant Purpose Transaction rather than a Principal Purpose Transaction, she could be subject to severe sanctions. As a result, a practitioner who has any doubts is likely to treat the arrangement as a Principal Purpose

Transaction out of an abundance of caution, thus subjecting both herself and her clients to additional burdens that may be expensive and unnecessary.

The terms “Principal Purpose Transaction” and “Significant Purpose Transaction” are not defined in the New Regulations. Nor are the available definitions from other sources helpful. Treasury Regulations Section 1.6662-4(g)(2)(i)(C) provides with respect to the definition of a tax shelter that “the principal purpose of an entity, plan or arrangement is to avoid or evade Federal income tax if that purpose exceeds any other purpose.” Treasury Regulations Section 301.6111-2(b)(3), regarding “confidential corporate tax shelters,” provides that the avoidance or evasion of Federal income tax will be considered a significant purpose of a transaction if the transaction “has been structured to produce Federal income tax benefits that constitute an important part of the intended results of the transaction.” Therefore, at least based on these definitions, for a Principal Purpose Transaction, the tax purpose has to exceed any other purpose, while for a Significant Purpose Transaction, the tax purpose has to constitute an important part of the arrangement.

In many instances it will be quite difficult for a practitioner to determine whether the tax aspect of a transaction exceeds any other aspect or is only an important aspect of the arrangement, especially with respect to the transfer taxes imposed by chapters 11 through 13 of the Code. Although the transfer of wealth usually is the main purpose of any gift or bequest, the transfer tax attributes of the arrangement selected could be interpreted as exceeding any other purpose for that particular transaction. For example, a testator might give property outright to her surviving spouse rather than provide for it to pass to a “credit shelter” trust for his benefit but for the fact that the trust will protect such property from estate taxes in both spouses’ estates. Does the fact that the testator chose the trust mechanism so as to minimize estate taxes mean that the tax purpose trumps her desire to benefit her spouse and therefore make the credit shelter trust arrangement a Principal Purpose Transaction? There is no clear answer to this question.

In light of the lack of certainty flowing from having both a principal purpose and a significant purpose test, we believe the New Regulations will be fairer and easier to administer if only the significant purpose test is retained. In that regard, we note that the 1997 amendment of the definition of tax shelter under Section 6662(d)(2)(C) replaced the principal purpose test with a significant purpose test. Assuming the regulations promulgated under Section 6662 are updated to reflect this change, the only relevant use of the principal purpose test in this context will be in the New Regulations. There is no apparent rationale for that exclusivity.

***C. Exclude Written Advice That Concludes There Is Not a Reasonable Basis for Tax Treatment Favorable to the Taxpayer***

Whatever definition of covered opinion is adopted, we believe that the definition of covered opinion should exclude written advice that concludes there is not a reasonable basis for the tax treatment the taxpayer seeks to achieve in connection with a particular transaction. Clearly it is in the government’s best interest to allow a practitioner to concisely advise a client that a proposed transaction is not effective to avoid tax.

Read literally, the New Regulations seem to provide that covered opinions include written statements about any listed transaction, any arrangement the principal purpose of which is tax avoidance or evasion, and in some cases any other arrangement a significant purpose of which is tax avoidance or evasion, even if the statement advises the taxpayer that favorable tax treatment will probably be denied. In fact, applied literally, the New Regulations seem to include written statements in those three areas even if the advice concludes that the taxpayer must report the transaction and that penalties may be imposed on the taxpayer.

Comments of Treasury officials suggest that such a literal construction of the Circular was not intended.<sup>27</sup> Imposing covered opinion requirements for such “negative” advice may reduce compliance with the tax law. Accordingly, we recommend that the Circular be revised to exclude written advice that concludes that there is not a reasonable basis that tax benefits from an arrangement will be allowed.

#### ***D. Clarify the Definition of Marketed Opinion***

The term “marketed opinion” should be defined differently. The current definition, which is set forth in paragraph (b)(5) of Circular Section 10.35, provides as follows:

- (5) Marketed opinion – (i) Written advice [concerning a Significant Purpose Transaction] is a marketed opinion if the practitioner knows or has reason to know that the written advice 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 a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).

This definition is not broad enough to reach all of the material it should reach. At the same time, a literal application of its terms could catch articles and outlines written for publication in periodicals and for distribution at seminars, e-mail exchanges on “list serves” and “blogs” and other informal discussions among professionals, material describing non-controversial tax techniques that appear in brochures, and written advice shared among related taxpayers.

Because the definition focuses on the use of the writing by a person other than the practitioner (or certain persons associated with the practitioner) to promote, market or

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<sup>27</sup> A Tax Notes article summarizing comments made by members of the Service and Treasury at the Federal Bar Association’s March 2005 tax law conference stated, “The government officials made clear that the Circular 230 provisions are not intended to cover negative advice. An e-mail from a practitioner to a client that says “no it does not work” after reviewing promotional materials on a deal is not something the government is going to worry about.” TREASURY, IRS OFFICIALS ADDRESS OPEN SHELTER GUIDANCE ISSUES, Tax Notes (March 21, 2005).

recommend a Significant Purpose Transaction, it fails to reach self-marketed opinions.<sup>28</sup> As an example, if a firm developed and marketed tax products to its own clients without the expectation that the clients would market those transactions to others, this type of marketed material would not be reached by the New Regulations' definition of marketed opinion. Because so many of the transactions that are now included in the Service's catalog of listed transactions had their genesis as tax products marketed in this way, we believe this kind of material should be treated as marketed opinions.

In contrast, the definition appears to reach written material that is unlikely to be used to promote or market any questionable tax scheme. This over-inclusiveness results (1) from the use of general terms in the definition such as “knows or has reason to know,” “used or referred to,” “recommending,” and “arrangement” that are ambiguous in their application, (2) from the failure to exclude written advice that does not address a significant Federal tax issue, and (3) from the failure to discriminate between (i) the sharing of written advice among related taxpayers or among the different parties participating in a particular transaction and (ii) the distribution of written advice as part of the marketing of a tax product.

A simple example will illustrate the problem caused by the general terms used in the definition. A tax practitioner prepares an article on the use of irrevocable life insurance trusts in estate planning and arranges for its publication in a periodical of wide circulation. The irrevocable life insurance trust offers a number of advantages, one of which is the exclusion of the death benefit from the gross estate of the insured. The article is intended as an educational piece. Should the practitioner know or have reason to know that a reader of the article may refer to the article when recommending an irrevocable life insurance trust and the purchase of a life insurance policy to one of her clients? If so, the article may fall within the definition of a marketed opinion. We do not believe that this result is intended.

The authors of the New Regulations could not have intended to discourage the publication of educational pieces by burdening the author with the requirements of a covered opinion. In order to avoid this possibility, the definition of “marketed opinion” should clearly exclude writings that are published as books or as articles in journals, magazines, and newspapers or posted on websites. In such cases the written piece reaches an indeterminate universe of readers and the author cannot know or anticipate what use one or more of the readers will make of it. Similarly, outlines that are delivered at professional conferences serve an educational purpose and the author cannot know whether one or more of the attendees at the conference may refer to the outline in recommending a tax-reducing arrangement to someone else. These outlines should also be excluded from the definition of “marketed opinion.”

Similarly, the New Regulations should make it clear that e-mail exchanges on list serves and other informal written discussions among professionals are not intended to be

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<sup>28</sup> See Lee A. Sheppard, SHELTER PENALTIES: OR ELSE WHAT? PART 2, Tax Notes Today (January 6, 2005).

caught within the definition of marketed opinion even though a participant may show the writing of another practitioner to one of her clients. List serves have become an increasingly popular and effective way of exchanging knowledge and viewpoints about tax issues. The authors of e-mail messages on list-serves do not know all of the potential recipients and should not have to determine whether or not their informal expressions of opinion may be used by another person to recommend an entity, investment plan or other arrangement. Requiring these types of informal exchanges, which are often the modern equivalent of a discussion group, to conform to the rigors of a covered opinion would have the effect of discouraging them.

To illustrate the problem caused by the failure to exclude written advice that does not address a significant Federal tax issue, consider the tax practitioner who, at the request of a charitable client, prepares a written piece about a standard tax and estate planning strategy, such as a charitable remainder trust, for inclusion in the client's planned giving brochure. Because the brochure is intended to be used by the charity to promote or recommend an arrangement, the practitioner's contribution appears to be captured by the definition of marketed opinion. This type of educational material should not be discouraged. Most important, the writing will not address any significant Federal tax issue, as such term is defined in the New Regulations. Indeed, the consequences of the use of charitable remainder trusts are comprehensively set forth in Treasury Regulations. This type of material would be protected from marketed opinion status if the definition were modified to exclude any written advice that does not address a significant tax issue.

To illustrate the problem caused by the failure to discriminate between the sharing of written advice among taxpayers and the distribution of written advice as part of the marketing of a tax product, consider the practitioner who gives a client written advice regarding a qualified personal residence trust (a "QPRT") as described in Treasury Regulations Section 25.2702-5(c). The client suggests to her father that he fund such a trust for the benefit of the client and the client's siblings. This type of written advice should not fall under the definition of a marketed opinion. It was not intended as a marketing device for a tax-advantaged transaction. It could be protected from marketed opinion status if the definition were modified to exclude material expected to be shared only among related taxpayers within the meaning of Section 267 or 707 or taxpayers who are co-participants in an investment or other transaction.

The New Regulations offer a way of electing out of marketed opinion status. Circular Section 10.35(b)(5)(ii) provides that written advice (other than advice concerning a listed transaction or a Principal Purpose Transaction) is not a marketed opinion if it prominently discloses that --

- (A) The advice was not intended or written by the practitioner to be used, and that it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer;
- (B) The advice was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice; and

(C) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

This provision is not an appropriate alternative to narrowing the definition. Not only would this disclosure be burdensome, distracting, and jarring, it would serve no useful purpose. The published article or e-mail message may be used or referred to in such a way that the taxpayer never sees the cautionary warnings in paragraphs (A) and (C). And the statement required by paragraph (B) would likely be false if it appeared in an article or e-mail or in a writing intended to be shared by related taxpayers.

We believe that the term "marketed opinion" should be defined to reach only opinions used to promote and market the sale of tax-driven transactions and that it should reach such opinions whether or not a third party is involved in marketing the transaction. It should not reach opinions that are shared by one individual with another without the expectation, in the case of the practitioner who prepared the opinion, of receiving a fee in excess of her normal hourly rate or, in the case of the individual for whom the opinion was prepared, of receiving a fee if a taxpayer with whom the opinion is shared decides to engage in the transaction. This approach would more appropriately address the concerns of the Service.

We suggest consideration be given to using the following definition:

(5) *Marketed opinion* – (i) Written advice is a *marketed opinion* if it concerns one or more significant Federal tax issues arising in connection with a transaction described in the opinion and -

(A) the practitioner who prepares such advice (or a person who is a member of, associated with, or employed by the practitioner's firm) distributes the advice to the practitioner's clients or to persons with whom the practitioner wishes to establish a client relationship with the expectation that, if a distributee engages in the transaction described in the advice, the practitioner will receive a fee in excess of the normal hourly charge or other normal method of calculating fees;<sup>29</sup> or

(B) the practitioner who prepares such advice (or a person who is a member of, associated with, or employed by the practitioner's firm) distributes it to another person with the expectation that the distributee will use the advice to promote or market the transaction to third parties from whom the distributee will collect a fee if such third party engages in the transaction.

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<sup>29</sup> An alternative approach would be to use as a benchmark the threshold amount for determining whether a person is a material advisor as set forth in Section 6111(b). For example, if the practitioner reasonably expects to receive for the opinion, or for organizing and implementing the transaction described in the opinion for a particular client, fees equal to the threshold amount (currently \$50,000 in the case of advice to an individual and \$250,000 in any other case) the advice could be treated as a marketed opinion.

If the definition is narrowed in this manner, we believe it would be appropriate to maintain the current method of electing out of marketed opinion status by the use of the disclosure described above.

***E. Extend the Covered Opinion Standards Now Applicable to Significant Purpose Transactions to all Covered Opinions***

Whatever definition of covered opinion is adopted, the requirements now applicable under the New Regulations to “reliance opinions” written in connection with Significant Purpose Transactions should apply to all covered opinions. As a result, the requirements with respect to reliance opinions would apply to any entity, plan or arrangement that may have risen to the level of a Principal Purpose Transaction as well as to those that constitute Significant Purpose Transactions. Similarly, written advice with respect to a listed transaction or written advice that constitutes a marketed opinion, is subject to conditions of confidentiality, or is subject to contractual protection, including advice with respect to a transaction that may be characterized as a Principal Purpose Transaction under the New Regulations as written, would be subject to the rules that, as written, apply only to Significant Purpose Transactions. We do not believe that such treatment would frustrate the goals of the New Regulations.

Including Principal Purpose Transactions in the Significant Purpose Transaction category will enable practitioners to elect out of all covered opinion requirements if they provide appropriate disclosures. It will also enable practitioners to give limited scope opinions with respect to such transactions. We believe practitioners should be able to elect out of the covered opinion requirements and provide limited scope opinions without first having to make the otherwise irrelevant determination that tax avoidance is only a significant purpose of the transaction, not its principal purpose.

Under the New Regulations, written advice concerning a Significant Purpose Transaction is a covered opinion by reason of the type of advice it contains<sup>30</sup> only if it addresses a significant Federal tax issue; that is, an issue as to which the Service has a reasonable basis for a successful challenge and the resolution of which could have a significant impact, whether beneficial or adverse, on the overall Federal tax treatment of the transaction or matters addressed in the opinion. Presumably, any transaction specifically sanctioned by the Code or regulations would not give rise to a significant tax issue because the Service would not have a reasonable basis for a successful challenge. Therefore, written advice with respect to such a transaction should not be required to meet the requirements of a covered opinion.

For example, the Service would not have a reasonable basis for a successful challenge to a transfer of a residence to a QPRT that met all the requirements of Treasury Regulations Section 25.2702-5(c). One of the reasons an individual creates and funds a

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<sup>30</sup> Written advice also can be classified as a covered opinion based on the type of opinion, *i.e.*, a marketed opinion or an opinion subject to conditions of confidentiality or contractual protection, without reference to the type of advice it contains.

QPRT, however, is to minimize gift taxes with respect to the transfer of the residence to her beneficiaries. If that reason is deemed a significant purpose of the transaction, the standards for a covered opinion would apply unless the written advice contains no advice concerning a significant Federal tax issue. Because none of the issues that normally arise in connection with the creation of a QPRT are likely to be significant Federal tax issues, written advice regarding the creation of the QPRT ought not constitute a covered opinion. It is unlikely, however, that an individual would use a QPRT to transfer a residence but for the potential gift tax savings. Therefore, the Service could conclude that the arrangement is a Principal Purpose Transaction. If so, the written advice would constitute a covered opinion notwithstanding the fact that the transaction does not give rise to a significant tax issue. Eliminating the distinction between Principal Purpose and Significant Purpose Transactions will avoid this potential trap.

There are many transactions sanctioned by the Code and regulations which do not raise significant tax issues but which could be deemed to constitute Principal Purpose Transactions. Such transactions include, for example, the QPRT discussed above, a transfer to a qualified terminable interest trust within the meaning of Sections 2056(b)(7) or 2523(f), or a transfer to an account that meets the requirements of Section 529. We believe that the New Regulations should be clarified to provide that any transaction that is sanctioned by the Code or otherwise does not involve a significant tax issue is not a Significant Purpose Transaction and, if the category is retained, also is not a Principal Purpose Transaction. We note that a similar concept is incorporated in Treasury Regulations Section 1.6662-4(g)(2)(ii) dealing with the now obsolete principal purpose test for tax shelters. That regulation provides that the principal purpose of an entity, plan or arrangement is not the avoidance or evasion of Federal income tax if the transaction has as its purpose the claiming of a tax benefit that is consistent with the Code and Congressional purposes. We recommend that a similar provision be added to the New Regulations to apply to any transaction that has the potential for avoiding Federal taxes regardless of whether the transaction is a Principal Purpose or a Significant Purpose Transaction.

#### ***F. Moderate the Disclosure Required to Elect Out of Covered Opinion Treatment***

Whether or not the definition and treatment of a covered opinion are limited in the manner recommended, but especially if they are not, clarification and modification should be provided to moderate the intrusiveness, potential offensiveness, and impracticality of the disclosure now required to avoid treating written advice concerning a Significant Purpose Transaction as a covered opinion.

Circular Sections 10.35(b)(2)(ii) and (b)(8) require that the written advice contain a statement that the advice is not intended to be used to avoid tax penalties and that the statement be set forth in a separate section at the beginning of the written advice in a bold typeface larger than any other typeface used in the written advice.

One of the concerns about the New Regulations most strenuously expressed by practitioners is the disruptive and unprofessional nature of such a banner on otherwise

routine attorney-client correspondence. Such a banner is likely to alarm clients, particularly those who are unsophisticated, and generally undermine the attorney-client relationship. There is no compelling reason related to the administration of the tax laws for such disruption of this time-honored relationship. Moreover, in some media such as e-mail, it might be impossible or excessively burdensome to comply with these requirements of location and typeface.

At a minimum, the requirement that the necessary disclosure be “prominently disclosed” or disclosed in any particular place in the writing should be deleted from the New Regulations. Any disclosure with the mandated content anywhere in the text of the written advice would serve the purpose of negating reasonable reliance. If Treasury and the Service are concerned about disclosure that is buried in an unusually long and tedious letter, that case could be addressed by requiring the disclosure to be included on the first page if the document has a total of more than, say, 25 pages. Such a long document would not be casual correspondence, and it would not be disruptive or unprofessional for it to have a summary at the beginning, which could include the necessary disclaimer. In contrast, the banner mandated by the “prominently disclosed” requirement will always be both disruptive and unprofessional and will degrade the legal profession for no good purpose.

In addition, a moderate approach to any disclosure requirement would permit it to be satisfied with a general disclaimer, for example in an engagement letter. If an appropriately important piece of correspondence from the practitioner to the client (particularly one that the client acknowledges in writing) clearly states that the client is not to use any written advice from the practitioner for the purpose of avoiding tax penalties unless the written advice explicitly states that it may be so used, then the purpose of the New Regulations would appear to be served. We do not believe, however, that the general disclaimer approach would be appropriate for a marketed opinion.

It is understandable that Treasury and the Service would be concerned about the taxpayer who would argue that it was reasonable to rely on a practitioner’s written advice despite a technical defect in the analysis that an ordinary layperson could not be expected to discern. The foregoing recommendations address that concern. If these recommendations are not thought to be enough, then Treasury and the Service could consider including such warnings in the tax returns themselves, or in the instructions. One approach might be to place such warnings in the signature field, like the “penalties of perjury” reference. Such warnings could be in whatever typeface the Service chose to use.

***G. Modify the Disclosure Requirements Applicable to Opinions Concerning a Significant Tax Issue When a More Likely Than Not Conclusion Is Not Necessary to Avoid Penalties***

If the term covered opinion is ultimately defined to include written advice concerning transactions for which a “more likely than not” opinion is not required to avoid penalties (as is the case based on the definition of “covered opinion” currently in the New Regulations) we recommend that Circular Sections 10.35(b)(4)(ii) and

10.35(e)(4)(ii) be modified to allow taxpayers to continue to rely on opinions, whether or not they are covered opinions, on issues that require only a reasonable basis level of confidence to avoid penalties.

Under the New Regulations, a covered opinion is an opinion regarding a Significant Purpose Transaction if it is a reliance opinion. Circular Section 10.35(b)(4) defines a reliance opinion as an opinion that reaches a confidence level of more likely than not, unless the opinion prominently discloses that it cannot be used to avoid penalties that may be imposed on the taxpayer. The disclosure required by Circular Section 10.35(b)(4)(ii) should be modified to say that the opinion may not be relied on to avoid those penalties that require a more likely than not opinion to avoid penalties.

For example, suppose that a practitioner gives written advice to her client concerning the gift tax consequences of a gift to an irrevocable trust for the client's descendants. The advice concerns whether the gift to the trust qualifies for the annual gift tax exclusion to the extent of each beneficiary's 30-day withdrawal right. Assume that this is a Significant Purpose Transaction. The client requires only a reasonable basis opinion in order to avoid tax penalties if the transaction is successfully challenged by the Service. If the practitioner gives the client a reasonable basis opinion, the opinion would not be treated as a reliance opinion and the client would be entitled to rely on the opinion to avoid penalties. However, assume further that the practitioner concludes not only that there is a reasonable basis for annual gift tax exclusion treatment but that annual gift tax exclusion treatment is more likely than not. The New Regulations seem to require that, in order to avoid having to comply with the standards relevant to a covered opinion, the practitioner must either give a lower level of confidence opinion (that is, a reasonable basis opinion) or, in the alternative, state that her client cannot rely on the opinion to avoid any penalties, even penalties the avoidance of which require only a reasonable basis opinion. If the client wants to have the practitioner's honest evaluation of the merits, which in this case would be a more likely than not opinion, the client is required to choose between (i) accepting an opinion with a disclosure statement saying that the client may not rely on the advice to avoid any penalties or (ii) paying for a formal covered opinion. This illogical result can be avoided if Circular Section 10.35(c)(4)(ii) is amended to say that an opinion is not a reliance opinion if it prominently states that "This opinion may not be relied upon to avoid penalties that require a more likely than not opinion."<sup>31</sup>

Similarly, a covered opinion that does not reach a more likely than not level of confidence with respect to any significant tax issue is required to prominently disclose this fact and to state that with respect to those issues the opinion cannot be used to avoid penalties. If an issue with respect to which the opinion concludes that there is a reasonable basis but not a more likely than not level of confidence requires only a reasonable basis opinion in order to avoid penalties, the client should be allowed to rely

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<sup>31</sup> For the purposes of this section III.G., we are assuming that a taxpayer who is required under Section 6664(d) to have a reasonable belief that her tax treatment of an item was more likely than not the proper treatment would obtain a more likely than not opinion.

on the reasonable basis opinion to avoid such penalties. In fact, any advice to the contrary is inconsistent with the tax law. This problem can be corrected by amending Circular Section 10.35(e)(4)(ii) to say that “With respect to those significant tax issues *which require a more likely than not opinion in order to avoid penalties*, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.”

***H. Clarify the Rules Limiting a Practitioner’s Ability to Discuss Audit Risks With Clients***

Circular Section 10.35(c)(3)(iii) provides as follows:

(iii) Evaluation based on chances of success on the merits. In evaluating the significant Federal tax issues addressed in the opinion, the practitioner must not take 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.

Circular Section 10.37(a) similarly provides that:

A practitioner must not give written advice (including electronic communications) concerning one or more Federal tax issues if the practitioner . . . 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.

Both of the above statements are consistent with other regulations. For example, Treasury Regulations Section 1.6662-4(g)(4)(i) provides that:

[A] taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled) –

(A) The taxpayer analyzes the pertinent facts and authorities . . . and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(B) The taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor’s analysis of the pertinent facts and authorities . . . and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.

Neither the Circular Sections nor the Treasury Regulations quoted above preclude a practitioner from discussing the likelihood of audit, the likely consequences of an audit or the prospects of settlement in evaluating whether it is advisable for the taxpayer to engage in a transaction. Rather, both the Circular Sections and the Treasury Regulations

say that the likelihood of an audit, the outcome of an audit or the prospects of settlement cannot be considered in determining whether the tax treatment is proper. That is, the legal analysis on the merits cannot be influenced by these factors.

An example of the distinction is advice whether a taxpayer should make a gift directly to a child or instead make a gift to a grantor retained annuity trust (a "GRAT") meeting the requirements of Treasury Regulations Section 25.2702-3. The practitioner is not precluded from advising the taxpayer that the amount of the gift depends upon a final determination of value, and if the gift is made to a GRAT, the client obtains protection from the gift tax consequences of a revaluation on audit. The GRAT instrument can be drafted so that if the value is changed, the retained annuity is adjusted so that the taxable gift is not significantly increased. A client who has very hard to value assets, such as a closely-held business interest, and very little liquidity to deal with a gift tax audit or deficiency, may be well-advised to make the gift to a GRAT rather than outright. Clearly, it is appropriate for the practitioner to advise the client of the benefits of a GRAT in light of the risk of an audit adjustment. The consequences of the audit in the case of a GRAT had no effect on the practitioner's legal analysis or conclusion about how the taxable gift is properly calculated when a taxpayer makes a gift to a GRAT.

However, some confusion arises from the preamble to the New Regulations, which provides:

Under Section 10.37 a practitioner must not give written advice if the practitioner:

\* \* \*

(4) 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 settled.

If and when amended regulations are issued, we recommend that clause (4) of the preamble be modified to read as follows:

(4) in evaluating the merits of 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 settled.

The recommended change accurately states the terms of Circular Section 10.37(a) and avoids creating an inference that discussions of audits and settlements is precluded.

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