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MEMORANDUM

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FROM: Harry Gordon Oliver II

RE: As of May 9, 2006
IRS Circular 230

The government recently promulgated new tax practitioner rules known as Circular 230¹. This is a brief overview of the rules that apply to *tax return positions* and to *written communications* made by a tax practitioner.

§10.34 Tax Return Position and Preparing Tax Returns

§10.34 sets the standard for advice with respect to tax return positions and for preparing or signing tax returns.

A practitioner may not advise a client to take a position on a tax return, or prepare a tax return, unless (1) the practitioner determines that the position satisfies the *realistic possibility standard*; or (2) the position is *not frivolous* and the practitioner *advises the client of any opportunity to avoid the accuracy related penalty* (IRC §6662) *by adequately disclosing* the position and of the requirements for adequate disclosure. Circular 230² §1034(a). A practitioner must inform a client of the *penalties reasonably likely to apply* and any opportunity to avoid any penalty by disclosure, and of the requirements for adequate disclosure. §10.34(b).

A realistic possibility standard is one that has approximately a one in three, or greater, likelihood of being sustained on its merits. §10.34(d)(1). A position is frivolous if it is patently improper. §10.34(d)(2).

§10.35 Requirements for Covered Opinions

§10.35 provides rules for so-called covered opinions. §10.35(a). A covered opinion must comply with the standard of practice set forth in §10.35. A covered opinion is any written advice regarding any federal tax issue arising from:

(1) A transaction that is the same as or substantially similar to a transaction that the IRS has determined to be tax avoidance and identified as a listed transaction. §10.35(b)(2)(i)(A);

¹Title 31, Code of Federal Regulations, Subtitle A, Part 10, Revised as of June 20, 2005.

²References are to Circular 230 unless otherwise indicated.

(2) Any entity, any investment plan or arrangement the *principal purpose* of which is the *avoidance* or *evasion* of any federal tax. §10.35(b)(2)(i)(B). The principal purpose is the purpose that exceeds any other purpose. §10.35(b)(1).;

(3) Any entity, investment plan or arrangement, a *significant purpose* of which is the *avoidance* or *evasion* of any federal tax, if the written advice is (1) a reliance opinion³; (2) a marketed opinion; (3) subject to a confidentiality agreement, or (4) subject to contractual protection. i)(C).

A covered opinion does not include:

(A) Any written advice if the practitioner is reasonably expected to provide subsequent written advice that satisfies the covered opinion requirements. §10.35(b)(2)(ii)(A);

(B) Written advice regarding qualified plans, state and local bonds, or SEC filed documents. §10.35(b)(2)(ii)(B)1,2, & 3;

(C) Written advice solely for one taxpayer after the taxpayer has filed a tax return. §10.35(b)(2)(ii)(D);

(D) Written advice given to an employer. §10.35(b)(2)(ii)(D), or

(E) Written advice that does not resolve a federal tax issue in the taxpayer's favor. §10.35(b)(2)(ii)(E),⁴

A written advice is a reliance opinion if the advice concludes at a confidence level of at least more likely than not (a greater than 50% likelihood)⁵ that one or more significant federal tax issues would be resolved in the taxpayer's favor. §10.35(b)(4)(i).

Very importantly, written advice is not treated as a reliance opinion if the practitioner prominently discloses in the written advice that the written advice was not intended or written by a practitioner to be used and that it cannot be used by the taxpayer to avoid penalties. §10.35(b)(4)(ii)⁶

A marketed opinion exists if the practitioner knows or should know that the written advice will be used or referred to by a person other than the practitioner in marketing or recommending to one or more taxpayers. §10.35(b)(5)(i).

³The typical written advice to a client would be a reliance opinion.

⁴Can not conclude to any extent in taxpayer's favor, i.e. can not conclude (1) not frivolous, (2) realistic possibility of success, (3) reasonable basis, or (4) substantial authority. If have favorable opinion, it is a covered opinion.

⁵A tax return can be prepared if it is believed that there is a one in three chance of prevailing. (§10.34(d)); and such a standard is not a covered opinion. It must be felt that an opinion that will be relied on by taxpayers to enter into a transaction must have a greater confidence level than just filing a tax return.

⁶This disclaimer cannot be used for listed transactions, principal purpose transactions, i.e., such transactions are reliance opinions.

Importantly, written advice is not treated as a marketed opinion if the practitioner prominently discloses that (1) the written advice was not intended or written by the practitioner to be used and that it cannot be used by any taxpayer to avoid penalties; (2) The advice was to support marketing a transaction; and (3) the taxpayer should seek independent tax advice. §10.35(b)(5)(ii)(A), (B), & (C).

A written advice is subject to conditions of confidentiality if a practitioner imposes on recipients a limitation of disclosure. §10.35(b)(6).

Contractual protection exists if the taxpayer has the right to a refund if the written advice is not sustained. §10.35(b)(7).

Conditions of confidentiality and contractual protection are covered opinions and cannot be taken out of covered opinion status by disclosures that they cannot be used to avoid penalties, etc.

The impact of the covered opinion rules is that a reliance opinion has to state that the opinion is not intended to be and cannot be used to avoid penalties because the requirements of a covered opinion are prohibitively burdensome. Similarly with respect to marketed opinions.

Importantly, pursuant to ~~in~~ the covered opinion rules, a practitioner who issues a reliance opinions (the kind a practitioner would give to a client) must (1) make every effort to determine all the facts, (2) use only reasonable factual assumptions, (3) relate the applicable law to the relevant facts, (4) not assume favorable resolution of any significant factual tax issue, or use unreasonable legal assumptions, (5) not use inconsistent legal analysis, (6) consider *all* significant federal tax issues, (7) conclude as to likelihood that will prevail on merits on each significant tax issue considered (or state that unable to conclude for some issues). §10.35(c). This is time consuming and expensive. **It is these requirements that limit the use of reliance (covered) opinions.**

Marketed opinions must provide a conclusion that the taxpayer will prevail on the merits at a confidence level of at least more likely than not with respect to each significant federal tax issue. §10.35(c)(3)(iv).

In certain situations an opinion that considers less than all significant federal tax issues may be provided. §10.35(c)(3)(v).

Finally, an opinion must provide an overall conclusion as to the likelihood that the federal tax treatment is the correct treatment and the reasons for such a conclusion. §10.35(c)(4)(i). For marketed opinions, the overall conclusion must be that the treatment is proper using the confidence level of at least more likely than not. §10.35(c)(4)(ii).

The new Circular 230 rules are tough, tedious, controversial, and likely to be changed, hopefully to be more reasonable.