# SECTION 10.35(b)(4)(ii) OF CIRCULAR 230 IS INVALID (BUT JUST IN CASE IT IS VALID, PLEASE NOTE THAT YOU CANNOT RELY ON THIS ARTICLE TO AVOID THE IMPOSITION OF PENALTIES)

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## I. INTRODUCTION

> The contents of this email are intended for the use and benefit of the addressed recipients only. The rules imposed by IRS Circular 230 require us to state that, unless it is expressly stated above or in an attachment hereto, any opinions expressed with respect to a significant tax issue are not intended or written by the practitioner to be used, and cannot be used by the recipient, for the purpose of avoiding penalties that may be imposed on the recipient or any other person who may examine this correspondence in connection with a Federal tax matter. If the reader of this message is not an addressee, you are hereby notified that any unauthorized review, use, disclosure, dissemination, distribution, or copying of this communication, or any of its contents, is strictly prohibited. If you have received this communication in error, please contact the sender by reply email and destroy all copies of the original message. If you have received this e-mail in error, please immediately notify Juan F. Vasquez, Jr. by telephone.

Anybody having any interaction with a tax practitioner over the last two years has no doubt seen a similar legend so many times that he or she is now immune to it. Since June 21, 2005,

the most recent date amendments to Circular 230[1] went into effect,[2] all savvy tax practitioners have written similar disclaimers and placed them on anything that they have written and sent to anyone about anything. As nightmares of penalties regarding written tax opinions under Circular 230 have haunted them since the December 2004 amendments,[3] such language (aptly referred to as a "no reliance" legend[4]) has probably appeared in every tax practitioner's e-mail, regardless of whether the e-mail is as trivial as discussing social lunch plans or as substantive as providing tax advice.

By providing the "no reliance" legend to any written tax advice, practitioners are protected from censure, suspension, or disbarment from practice before the Internal Revenue Service ("IRS") as a result of such written product.[5] But what is the impact of the above "no reliance" disclaimer on clients? In short, clients seeking tax advice found themselves in a worse position on June 21, 2005 than the day before, for a number of reasons. One reason is that by the very terms of the above "no reliance" disclaimer, clients can no longer rely on the written advice of their tax advisors to avoid the imposition of accuracy-related penalties. Another major reason is that if clients want written tax advice to protect themselves from penalties, the price of obtaining it is considerably higher than what it was on June 20, 2005.[6]

The expansion of Circular 230 in December 2004 is a troubling misstep in the ongoing struggle by the IRS and the Treasury Department ("Treasury") to regulate tax practitioners. As the IRS attempted to "protect" taxpayers from the promotion of abusive tax shelters in its quest to crack down on the avoidance of tax, questions remained regarding whether the current Circular 230 regulations have intrusively expanded governmental regulation of tax practitioners beyond

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1. The regulations discussed in this article fall within Treasury Department Circular No. 230, 31 C.F.R. Subtitle A, Part 10 and are referred to collectively in the text as "Circular 230."

2. *E.g.*, 31 C.F.R. §§ 10.33(c), 10.35(g), 10.36(b), 10.37(b), 10.52(b) (2006).

3. 69 Fed. Reg. 75,842 (Dec. 20, 2004).

4. David T. Moldenhauer, *Circular 230 Opinion Standards, Legal Ethics and First Amendment Limitations on the Regulation of Professional Speech by Lawyers*, 29 SEATTLE U. L. REV. 843, 845 (2006). The term derives from § 10.35(b)(4)(ii), (c)(3)(v). *Id.* at 845 n.16.

5. By implication, a practitioner will not be censured, suspended, or disbarred for violations of Circular 230 relating to misunderstanding, confusion, or negligence. *See* 31 C.F.R. § 10.50(a).

6. *See* Richard M. Lipton, *Attorney Comments on Proposed Circular 230 Amendments*, TAX NOTES TODAY, Mar. 11, 2004, *available at* 2004 LEXIS TNT 48-41.

Constitutional or acceptable realms, and whether they accurately reflect the intent of Congress when it enacted § 822 of the American Jobs Creation Act of 2004.[7]

## II. SECTION 10.35(b)(4) AND THE "NO RELIANCE" DISCLAIMER

The genesis of the "no reliance" disclaimer is § 10.35(b)(4) of Circular 230.[8] Section 10.35 generally discusses the requirements for providing written tax advice called a "covered opinion."[9] Generally, a covered opinion is "written advice (including electronic communications) by a practitioner concerning one or more Federal tax issues"[10] and includes written advice concerning a listed transaction,[11] a tax shelter (i.e., device whose "principal purpose" is to avoid tax),[12] or "significant purpose" tax avoidance or evasion transactions in which the written advice is either: 1) a reliance opinion, 2) a marketed opinion, 3) subject to conditions of confidentiality, or 4) subject to contractual protection.[13] This article concerns the expansive definition of a "reliance opinion," described in § 10.35(b)(4) as follows:

> Reliance opinion—(i) 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 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor.
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> (ii) For purposes of this section, written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion), is not treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of

7. Pub. L. No. 108-357, § 822, 118 Stat. 1418, 1586-87.
8. 31 C.F.R. § 10.35(b)(4).
9. *Id.* § 10.35.
10. *Id.* § 10.35(b)(2)(i) (emphasis omitted).
11. *Id.* § 10.35(b)(2)(i)(A) (citing 26 C.F.R. § 1.6011-4(b)(2)).
12. *Id.* § 10.35(b)(2)(i)(B).
13. *Id.* § 10.35(b)(2)(i)(C).

> avoiding penalties that may be imposed on the taxpayer.[14]

To put § 10.35(b)(4) into perspective, one need look no further than the phrase "a significant purpose of which is the avoidance or evasion of any tax" contained in § 10.35(b)(2)(i)(C).[15] Conveniently, Circular 230 does not define the phrase, nor do the Internal Revenue Code, Treasury Regulations, and published court cases define the term "significant purpose." To make matters worse, the IRS is on record as stating not to "expect to see a definition of significant purpose."[16] This leaves tax lawyers, Certified Public Accountants ("CPA"s), enrolled agents, and all other tax practitioners who try to comply with the "letter of the law" quickly realizing that the very essence of their practice (providing tax advice regarding transactions) fits the definition of a "significant purpose of which is the avoidance or evasion of any tax."[17] Every I.R.C. § 1031 like-kind exchange,[18] formation of a trust for estate tax purposes, and advice regarding a corporate reorganization, choice of entity, etc., is arguably a "significant purpose of which is the avoidance or evasion of any tax."[19] Consequently, every piece of written advice from a tax practitioner must contain the "no reliance" disclaimer unless "the advice concludes at a confidence level of at least more likely than not (a greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor."[20] The list of writings that must contain the "no reliance" disclaimer is not limited to traditional opinion letters, but includes e-mails, letters, and anything else in written form.[21]

If the practitioner cannot reach a "more likely than not" level of confidence, or if the client is unwilling to pay the practitioner to take the time to compose a written product ensuring such confidence level, § 10.35(b)(4)(ii) mandates that the practitioner include the "no reliance" phrase on the written product.[22] If a

14. *Id.* § 10.35(b)(4) (emphasis omitted).

15. *Id.* § 10.35(b)(2)(i)(C); *see also id.* § 10.35(b)(4).

16. Sheryl Stratton, *ABA Tax Section Meeting: Tax Officials Spar with Tax Bar over Circular 230*, 107 TAX NOTES 1082, 1083 (2005).

17. *See* 31 C.F.R. § 10.35(b)(2)(i)(C); Richard M. Lipton, Robert S. Walton & Steven R. Dixon, *The World Changes: Broad Sweep of New Tax Shelter Rules in AJCA and Circular 230 Affect Everyone*, 102 J. TAX'N 134, 147 (2005) ("[A] tax shelter is any plan or arrangement with a significant purpose of tax avoidance or evasion—which is essentially everything that most tax planners do.").

18. *See* I.R.C. § 1031 (West 2000 & Supp. 2006).

19. *See* 31 C.F.R. § 10.35(b)(2)(i)(C).

20. *Id.* § 10.35(b)(4)(i).

21. *See id.* § 10.35(b)(2).

22. *Id.* § 10.35(b)(4)(ii).

client is relying on a tax practitioner to provide guidance on whether or not to make a certain transaction, certainly the practitioner's inability to reach a "more likely than not" confidence level could impact the client's decision regarding whether to proceed with the transaction. With that said, there are many cases in which the taxpayers ultimately prevail in court in the face of IRS assertions that the taxpayers have less than a fifty percent chance of success.[23] Accordingly, if a client cannot rely on the advice of a tax practitioner for the avoidance of penalties, the practitioner's advice seems pretty useless.

## III. HISTORY OF CIRCULAR 230

### A. *Circular 230 from 1966-2003*

Circular 230 was promulgated as 31 C.F.R. pt. 10 in 1966[24] and has been amended fifteen times since then.[25] However, it was not until the 2003 amendments,[26] effective beginning December 20, 2004[27] and largely applicable after June 21, 2005,[28] that most tax practitioners really became aware of, or concerned with, Circular 230.

In 1984, the Treasury amended § 10.33 of Circular 230 to regulate the content of tax shelter opinions.[29] The 1980 preamble to those regulations in proposed form provided:

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23. It is important to note that the IRS has on many occasions claimed that a transaction is a "tax shelter" or "sham," only to be rebuffed by courts who determine that the transactions in question had business purpose. *See, e.g.*, IES Indus., Inc. v. United States, 349 F.3d 574, 582 (8th Cir. 2003), *aff'g* 253 F.3d 350 (8th Cir. 2001); Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 787-88 (5th Cir. 2001); United Parcel Serv. of Am. v. Comm'r, 254 F.3d 1014, 1020 (11th Cir. 2001); TIFD III-E, Inc. v. United States, 342 F.Supp.2d 94, 108-09 (D. Conn. 2004), *rev'd on other grounds* 459 F.3d 220 (2d Cir. 2006).

24. 31 Fed. Reg. 10,773 (Aug. 13, 1966) (to be codified at 31 C.F.R. pt. 10).

25. *See* 71 Fed. Reg. 13,018 (Mar. 14, 2006); T.D. 9201, 2005-23 I.R.B. 1153; T.D. 9165, 2005-4 I.R.B. 357; T.D. 9011, 2002-2 C.B. 356; T.D. 8545, 1994-2 C.B. 415; 57 Fed. Reg. 41,093 (Sep. 9, 1992); 51 Fed. Reg. 2,875 (Jan. 22, 1986); 50 Fed. Reg. 42,014 (Oct. 17, 1985); 49 Fed. Reg. 7,116 (Feb. 27, 1984); 49 Fed. Reg. 6,719 (Feb. 23, 1984); 44 Fed. Reg. 4,940 (Jan. 24, 1979); 42 Fed. Reg. 38, 350 (Jul. 28, 1977); 37 Fed. Reg. 1,016 (Jan. 21, 1972); 36 Fed. Reg. 8,671 (May 11, 1971); 35 Fed. Reg. 13,205 (Aug. 19, 1970). In addition, three minor corrections have been made to Circular 230. *See* 70 Fed. Reg. 20,805 (April 21, 2005); 70 Fed. Reg. 19,892 (April 15, 2005); 70 Fed. Reg. 19,559 (April 13, 2005).

26. 68 Fed. Reg. 75,186 (proposed Dec. 30, 2003) (codified at 31 C.F.R. pt. 10).

27. T.D. 9165, 2005-4 I.R.B. 357, 357.

28. 69 Fed. Reg. 75,839, 75,839-45 (Dec. 20, 2004) (to be codified at 31 C.F.R. pt. 10); *see supra* note 2 and accompanying text.

29. 49 Fed. Reg. 6,719 (Feb. 23, 1984).

> The theory of the tax shelter promoter appears to be that the tax opinion, even if qualified or simply incorrect, may provided [sic] the investor with assurance that penalties will not be assessed . . . . Moreover, promoters also appear to hope that investors will view the practitioner's willingness to provide an opinion, even when the opinion is frankly pessimistic . . . or simply does not purport to address key tax aspects, as an endorsement of the tax shelter.[30]

The preamble to the subsequent 1982 revised proposed regulations also made clear that Circular 230 would not "affect or regulate the practitioner's relationship with individual clients."[31] It further stressed that Circular 230 regulates the use of tax shelter opinions specifically rather than all attorney opinions generally for use by their clients, and that Circular 230 was consistent with American Bar Association ("ABA") Formal Opinion 346[32] regarding tax shelter opinions.[33] The 1984 amendments to Circular 230 define a "tax shelter opinion" as "advice by a practitioner concerning the Federal tax aspects of a tax shelter either appearing or referred to in the offering materials, or used or referred to in connection with sales promotion efforts, and directed to persons other than the client who engaged the practitioner to give the advice."[34] Thus, it is clear that when the Treasury originally became involved in regulating written tax advice, it did so only as to marketed tax shelters opinions, and in a fashion consistent with guidance issued by the American Bar Association.[35]

### B. *The 2004 Amendments to Circular 230*

The motives and modus operandi of the Treasury and IRS have changed dramatically in the twenty-three years since the enactment of the 1984 amendments to Circular 230.[36] This is

30. 45 Fed. Reg. 58,594, 58,595 (proposed Sept. 4, 1980) (to be codified 31 C.F.R. pt. 10).

31. 47 Fed. Reg. 56,144, 56,146 (Dec. 15, 1982) (to be codified at 31 C.F.R. pt. 10).

32. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (1982).

33. 47 Fed. Reg. 56,144, 56,146 (Dec. 15, 1982) (to be codified at 31 C.F.R. pt. 10).

34. 49 Fed. Reg. 6719, 6723 (Feb. 23, 1984).

35. *Id.*; Arthur L. Bailey, *New Circular 230 Regulations Impose Strict Standards for Tax Practitioners*, THE TAX EXECUTIVE, Jan.-Feb., 2005, *available at* http://www.findarticles.com/mi_m6552/is_1_57/ai_n13478973; *see also* ABA Formal Op. 346.

36. *See generally* Bailey, *supra* note 35 (chronicling various changes that have occurred since 1984).

perhaps a result of Congress's enactment of § 822(b) of the American Jobs Creation Act of 2004, which provides that "[n]othing . . . shall be construed to limit the authority of the Secretary of the Treasury to impose standards applicable to the rendering of written advice . . . which is of a type which the Secretary determines as having a potential for tax avoidance or evasion."[37] While one may argue that the plain meaning of § 822 clearly authorizes the Secretary of the Treasury to issue Circular 230[38] addressing written tax advice if it has "a potential for tax avoidance or evasion,"[39] one must look no further than the same tax act to discover that "Congress deliberately targeted its burdensome opinion standards to situations where there is a risk of shelter activity."[40] It is also worth noting that neither the plain language of § 822 nor the legislative history discuss Congressional intent to amend the penalties imposed on those who receive written tax advice.[41] Finally, the legislative history

37. Pub. L. No. 108-357, § 822(b), 118 Stat. 1418, 1587 (2004).

38. *Id.*; *see* United States v. Ron Pair Enters., Inc., 489 U.S. 235, 242 (1989) ("The plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.'") (quoting Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982)); Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-43 (1984) ("If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."); Koshland v. Helvering, 298 U.S. 441, 447 (1936) ("But where, as in this case, the provisions of the [IRC] are unambiguous, and its directions specific, there is no power [for the Treasury] to amend it by regulation."); Withrow v. Roell, 288 F.3d 199, 203 (5th Cir. 2002) ("Statutory interpretation begins, of course, 'with the plain language of the statute. When the language [of the statute itself] is plain we must abide by it . . . .") (alteration in original) (quoting Moosa v. INS, 171 F.3d 994, 1008 (5th Cir. 1999)); Uniroyal Chem. Co. v. Deltech Corp., 160 F.3d 238, 244 (5th Cir. 1998), *modified on reh'g*, 160 F.3d 258 (5th Cir. 1999) ("When [statutory] language is plain we must abide by it; we may depart from its meaning only to avoid a result so bizarre that Congress could not have intended it.") (internal quotation marks omitted) (quoting Demarest v. Manspeaker, 498 U.S. 184, 191 (1991)); Swallows Holding, Ltd. v. Comm'r, 126 T.C. 96, 129 (2006) ("When a statute's provisions are unambiguous, and its directive is specific, the Secretary [of the Treasury] has no power to amend that statute by regulation."); *see also* Juan F. Vasquez, Jr. & Peter A. Lowy, *Challenging Temporary Treasury Regulations: An Analysis of the Administrative Procedure Act, Legislative Reenactment Doctrine, Deference, and Invalidity*, 3 HOUS. BUS. & TAX L.J. 248, 272 (2003) ("[I]f the statute under review is unambiguous, . . . the court must follow the expressed intent of Congress.").

39. American Jobs Creation Act of 2004, § 822(b), 118 Stat. at 1587; *see also* JOINT COMM. ON TAX'N, 109TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 379 (Comm. Print 2005), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2005_joint_committee_on_taxation&docid=f:21118.pdf [hereinafter TAX LEGISLATION ENACTED IN THE 108TH CONGRESS] (explaining that one reason for the change was "to curb the participation of tax advisors in both tax shelter activity and any other activity that is contrary to Circular 230 standards").

40. Jeffrey H. Paravano & Melinda L. Reynolds, *The New Circular 230 Regulations–Best Practices or Scarlet Letter?*, 46 TAX MGMT. MEMO 339, 340 (2005).

41. *See* American Jobs Creation Act of 2004, § 822, 118 Stat. at 1587; *see generally*

of § 822 merely restates the Congressional language and thus does not provide any guidance as to Congressional intent.[42] Specifically, the Senate Report explains that "[t]he provision also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion."[43]

Upon the issuance of Circular 230 in final form, the IRS seemingly confirmed that the regulation was directed at tax shelters and other highly egregious transactions. In a 2004 IRS News Release, Commissioner Mark W. Everson stated, "These new standards send a strong message to tax professionals considering selling a questionable product to clients. . . . The new provisions give us more tools to battle abusive tax avoidance transactions and to rein in practitioners who disregard their ethical obligations."[44] The IRS further stated that "[e]nsuring that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law is one of the IRS'[s] top four enforcement goals. The revisions to Circular 230 represent a key component of the strategy to achieve this goal."[45]

As part of this concerted effort on the part of the IRS to strengthen professional standards, Everson appointed former Justice Department prosecutor Cono Namorato to the position of Director of the IRS Office of Professional Responsibility ("OPR").[46] The OPR enforces the Circular 230 standards through investigation of misconduct claims against tax practitioners.[47] Namorato stated,

> The playing field for tax advisors has changed with these standards for tax opinions, the new penalties that Congress recently enacted and other steps the IRS has taken to detect and deter abusive transactions. . . . Most professionals share our concern about the egregious behavior of some of their colleagues and we appreciate the efforts of responsible practitioners to promote ethical practice. We are taking steps to ensure that all

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TAX LEGISLATION ENACTED IN THE 108TH CONGRESS, *supra* note 39.

42. TAX LEGISLATION ENACTED IN THE 108TH CONGRESS, *supra* note 39, at 378-79.

43. S. REP. NO. 108-192, at 110 (2003).

44. I.R.S. News Release IR-2004-152 (Dec. 17, 2004), *available at* http://www.irs.gov/irs/article/0,,id=132445,00.html.

45. *Id.*

46. *Id.*

47. *Id.*

> practitioners live up to their professional obligations.[48]

Before Namorato stepped down from OPR in 2006, he doubled the size of the OPR staff, resulting in increased effectiveness of the OPR.[49] Despite Namorato's assurances that the measures taken by the IRS reflected the shared concerns of tax professionals towards the "egregious behavior of some of their colleagues,"[50] commentary after commentary and article after article reflect the frustration of tax practitioners at large over the current version of § 10.35(b)(4)(ii) of the Circular 230 regulations. Ironically, in 2004 then Acting Assistant Secretary for Tax Policy Greg Jenner stated, "[t]hese revisions to Circular 230 strike an appropriate balance between tightening practitioner standards and minimizing burden on everyday advice . . . . These rules target the types of written advice that present a significant cause for concern and avoid undue interference with the practitioner-client relationship."[51]

This heavy-handed approach to regulation of tax practitioners is in stark contrast to former times when tax practitioners self-regulated through industry standards as established by professional organizations.[52] The modus operandi of the Treasury and IRS has also changed considerably since 1984, when former § 10.33 of Circular 230 closely mirrored ABA Formal Opinion 346 regarding written opinions on tax shelters.[53] Section 10.35 is much more stringent and reflects the change in the Treasury's approach to a tax practitioner's professional responsibilities.[54] By the plain meaning of § 10.35, the IRS and Treasury are now targeting any and all written tax advice, not just marketed tax shelter opinions.[55] In addition, not only have the Treasury and IRS not worked hand in hand with the ABA Section of Taxation in implementing the changes to Circular 230, they have disregarded comments from the Section of Taxation

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48. *Id.*

49. *Id.*; *see* Caplin & Drysdale, Attorneys: Cono R. Namorato, http://www.capdale.com/cnamorato (last visited Apr. 20, 2007).

50. I.R.S. News Release IR-2004-152.

51. *Id.*

52. *See* Moldenhauer, *supra* note 4, at 867.

53. Bruce D. Pingree, *Circular 230 and Tax Shelter Issues in Benefits* (ALI-ABA Course of Study: Current Pension and Employee Benefits Law and Practice, July 7, 2006) SM046 ALI-ABA 1059, 1061; Moldenhauer, *supra* note 4, at 885 (citing Joslin v. Sec'y of Dep't of Treasury, 616 F. Supp. 1023, 1026 (1985)); *see also supra* notes 32-33 and accompanying text.

54. *See* Moldenhauer, *supra* note 4, at 869-70.

55. *See* 31 C.F.R. § 10.35(b)(2) (2006).

and many other commentators regarding the shortcomings of § 10.35(b)(4).[56]

## IV. SECTION 10.35(b)(4)(ii)'S "NO RELIANCE" DISCLAIMER SEEKS TO EVISCERATE SECTIONS OF THE INTERNAL REVENUE CODE, TREASURY REGULATIONS, AND YEARS OF COURT PRECEDENT

In spite of the apparent authority of the IRS to issue Circular 230 as expressed in § 822(b) of The American Jobs Creation Act of 2004[57] and the strong IRS rhetoric upon finalization of the regulations, one must dig deeper to discover that the IRS, with Congress's inadvertent permission, has attempted to revoke sections of the Internal Revenue Code and Treasury Regulations, and to overrule countless court cases standing for the proposition that one can rely on his tax advisor to avoid the imposition of accuracy-related penalties under I.R.C. § 6662.

### A. *Reasonable Cause and Good Faith Exception to Accuracy-Related Penalties Generally*

Accuracy-related penalties under I.R.C. § 6662, including those based on "negligence or disregard of rules or regulations" and "substantial understatement of income tax,"[58] are inapplicable if a taxpayer relied in good faith upon the advice of a professional tax advisor.[59] Under § 6664(c)(1), no accuracy-related penalty "shall be imposed under [§ 6662] with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion."[60] "Reasonable" is defined in Webster's Dictionary as "not absurd," "not ridiculous," "not extreme," and "not excessive."[61]

The Fifth Circuit has long recognized the reasonable cause defense to penalties.[62] "The determination of whether a taxpayer

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56. *See, e.g.*, ABA SECTION OF TAXATION, COMMENTS ON PROPOSED RULEMAKING: CIRCULAR 230 (Feb. 12, 2004), *available at* http://www.abanet.org/tax/pubpolicy/2004/040212stp.pdf; *see also infra* Part V.

57. *See* American Jobs Creation Act of 2004, § 822(b), Pub. L. No. 108-357, 118 Stat. 1418, 1587 (2004); I.R.S. News Release IR-2004-152 (Dec. 17, 2004), *available at* http://www.irs.gov/irs/article/0,,id=132445,00.html.

58. I.R.C. § 6662(b)(1)-(2) (West 2000 & Supp. 2006).

59. Treas. Reg. § 1.6662-1 (as amended in 1995); Treas. Reg. § 1.6664-4 (as amended in 2003); *e.g.*, Stanford v. Comm'r, 152 F.3d 450, 460 (5th Cir. 1998); *see* I.R.C. § 6664(c)(1).

60. I.R.C. § 6664(c)(1); Treas. Reg. § 1.6664-4(a).

61. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1892 (1986).

62. *See e.g.*, *Stanford*, 152 F.3d at 460-61; Pan Am. Life Ins. Co. v. United States,

acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances"[63] surrounding the substance of the transaction, the taxpayer's reliance upon professional advice, and any opinions the taxpayer received.[64]

"Reliance on . . . professional advice . . . constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith."[65] With respect to reliance on professional opinions or advice, "[a]ll facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law."[66] Factors relevant to this determination include the taxpayer's "education, sophistication, and business experience."[67]

In *Stanford v. Commissioner*, the Fifth Circuit vacated the IRS's imposition of accuracy-related penalties on the grounds that the taxpayers made sufficient efforts to assess their proper tax liability,[68] which the court concluded to be the most important factor in determining the presence of the reasonable cause and good faith exception.[69] The taxpayers relied on the advice of an attorney for international structuring and a CPA for preparation of their tax return and determination of certain deductions under I.R.C. § 952.[70] The court aptly noted that "[t]o require the taxpayer to challenge the [professional advisor], to seek a 'second opinion,' or to try to monitor [the professional advisor] on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place."[71]

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174 F.3d 694, 697 (5th Cir. 1999); Streber v. Comm'r, 138 F.3d 216, 223 (5th Cir. 1998); Reser v. Comm'r, 112 F.3d 1258, 1271 (5th Cir 1997); Durrett v. Comm'r, 71 F.3d 515, 517-18 (5th Cir. 1996); Chamberlain v. Comm'r, 66 F.3d 729, 732-33 (5th Cir. 1995); Westbrook v. Comm'r, 68 F.3d 868, 881 (5th Cir. 1995); Heasley v. Comm'r, 902 F.2d 380, 383-84 (5th Cir. 1990).

63. Treas. Reg. § 1.6664-4(b)(1); *see also Reser*, 112 F.3d at 1271.

64. *See* Treas. Reg. § 1.6664-4(b)(1).

65. *Id.*

66. *Id.* § 1.6664-4(c)(1).

67. *Id.*

68. *See* Stanford v. Comm'r, 152 F.3d 450, 463 (5th Cir. 1998).

69. *Id.* at 460-61 (citing Streber v. Comm'r, 138 F.3d 216, 223 (5th Cir. 1998); Treas. Reg. § 1.6664-4(b)).

70. *Id.* at 461.

71. *Id.* (quoting Chamberlain v. Comm'r, 66 F.3d 729, 7333 (5th Cir. 1995)).

The case of *Chamberlain v. Commissioner* is particularly relevant to the negligence penalty under I.R.C. § 6662(b)(1). In *Chamberlain*, the Fifth Circuit reversed the Tax Court's imposition of the negligence penalty for deductions claimed by the taxpayers relating to sham transactions.[72] Despite the sham nature of the underlying transactions, the court held that the taxpayers' reliance on professional advice in claiming the deductions constituted a defense to the negligence penalty.[73]

### B. *Accuracy-Related Penalties Related to Negligence Can Be Avoided if Taxpayer Has Reasonable Basis for Return Position*

Under I.R.C. § 6662(c), "the term 'negligence' includes any failure to make a reasonable attempt to comply with the provisions of [Title 26], and the term 'disregard' includes any careless, reckless, or intentional disregard" of rules or regulations.[74] Pursuant to Treas. Reg. § 1.6662-3(b)(1),

> The term negligence includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. "Negligence" also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly.[75]

The same Regulation provides the following examples as strong indications of negligence:

> 1. A taxpayer fails to include on an income tax return an amount of income shown on an information return . . . ;
>
> 2. A taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be "too good to be true" under the circumstances;

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72. *See Chamberlain*, 66 F.3d at 732-33.

73. *See id.*

74. I.R.C. § 6662(c) (2000); *see also Streber*, 138 F.3d at 219 ("Negligence includes any failure to reasonably attempt to comply with the tax code, including the lack of due care or the failure to do what a reasonable or ordinarily prudent person would do under the circumstances.") (quoting Heasley v. Comm'r, 902 F.2d 380, 383 (5th Cir. 1990)).

75. Treas. Reg. § 1.6662-3(b)(1) (as amended in 2003).

> 3. A partner fails to . . . treat partnership items on its return in a manner that is consistent with the treatment of such items on the partnership return . . . ; or
>
> 4. A shareholder fails to comply with the requirements of [I.R.C. §] 6242 . . . .[76]

According to Treasury Regulation § 1.6662-3(b)(2):

> A disregard of rules or regulations is "careless" if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation. A disregard is "reckless" if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. A disregard is "intentional" if the taxpayer knows of the rule or regulation that is disregarded.[77]

A return position is not negligent if it has a reasonable basis[78] and presents more than a "merely arguable or . . . colorable claim."[79] However, "[i]f a return position is reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard . . . ."[80] Authorities listed in Treasury Regulation § 1.6662-4(d)(3)(iii) include Code provisions; proposed, temporary, and final Treasury Regulations; revenue rulings and revenue procedures; court cases; congressional committee reports; and other legislative history.[81]

76. *Id.*

77. *Id.* § 1.6662-3(b)(2).

78. *Id.* § 1.6662-3(b)(1).

79. *Id.* § 1.6662-3(b)(3).

80. *Id.*; *e.g.*, Bunney v. Comm'r, 114 T.C. 259, 267 n.10 (2000) (citing Treas. Reg. § 1.6662-4(d)(3)(iii)) (private letter rulings).

81. Treas. Reg. § 1.6662-4(d)(3)(iii) (as amended in 2003).

### C. *Substantial Understatement Accuracy-Related Penalties Can Be Avoided if Taxpayer Has Substantial Authority or Reasonable Basis for Return Position*

With respect to the substantial understatement penalty under I.R.C. § 6662(b)(2),[82] in addition to the reasonable cause and good faith defense discussed above,[83] taxpayers also have another substantial authority defense.[84] Under I.R.C. § 6662(d)(2)(B), "[t]he amount of the understatement . . . shall be reduced by that portion of the understatement which is attributable to—(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment . . . ."[85] Treasury Regulation § 1.6662-4(d)(1) provides:

> If there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the return for the taxable year in computing the amount of tax shown on the return. Thus, for purposes of [I.R.C. §] 6662(d), the tax attributable to the item is not included in the understatement for that year.[86]

The substantial authority standard is objective[87] and exists when "the weight of the authorities supporting the treatment is substantial in relation to the weight of the authorities supporting contrary positions."[88] Most importantly, the "substantial authority [standard] is less stringent than the more-likely-than-not standard, but stricter than a reasonable basis standard."[89] The authorities that may be considered in determining whether substantial authority exists are the same as those for the reasonable basis standard listed above.[90] Accordingly, taxpayers who satisfy the substantial authority standard will clearly also satisfy the reasonable basis standard referred to in I.R.C.

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82. I.R.C. § 6662(b)(2) (West 2000 & Supp. 2006).

83. *See* discussion *supra* Part IV.A.

84. *See* I.R.C. § 6662(d)(2)(B)(i) (2000); Treas. Reg. § 1.6662-4(d).

85. I.R.C. § 6662(d)(2)(B)(i).

86. Treas. Reg. § 1.6662-4(d)(1).

87. *Id.* § 1.6662-4(d)(2) (West 2000 & Supp. 2006).

88. Westbrook v. Comm'r, 68 F.3d 868, 882 (5th Cir. 1995) (quoting Treas. Reg. § 1.6661-3(b)(1)); Treas. Reg. § 1.6662-4(d)(3)(i).

89. Norgaard v. Comm'r, 939 F.2d 874, 880 (9th Cir. 1991); Treas. Reg. § 1.6662-4(d)(2). "More likely than not" means "a greater than 50-percent likelihood of the position being upheld." Treas. Reg. § 1.6662-4(d)(2).

90. *See* Treas. Reg. § 1.6662-4(d)(3)(iii), 1.6662-4(d)(2); *see also supra* notes 80-81 and accompanying text.

§ 6662(d)(2)(B).[91] Although opinions rendered by tax professionals are not considered "authority," "[t]he authorities underlying such expressions of opinion where applicable to the facts of a particular case . . . may give rise to substantial authority for the tax treatment of an item."[92]

As noted by the Code, Treasury Regulations, and courts at all levels, taxpayers have long been able to rely on reasonable basis or substantial authority levels of opinions, whether written or oral, as part of their reasonable cause defense to avoid the imposition of accuracy-related penalties.[93] It is without question that these levels of authority are below Circular 230's mandated "more likely than not" standard and avoid inclusion of the no reliance disclaimer.[94] Surely the Treasury did not intend such a result.

## V. SECTION 10.35 VIOLATES THE SPIRIT OF THE ADMINISTRATIVE PROCEDURE ACT

### A. *Circular 230 Is a Legislative Regulation Subject to Notice and Comment Proceedings*

An interpretive regulation is issued under a general grant of Congressional authority under I.R.C. § 7805(a), which authorizes the Secretary of the Treasury to "prescribe all needful rules and regulations for enforcement of [the tax laws]."[95] But "interpretive regulations purport only to interpret, explain, and apply" such rules and regulations.[96] On the other hand, legislative regulations are issued pursuant to specific grants of Congressional authority, meaning that for various Code sections, Congress includes a specific designation of authority to the

91. *See* I.R.C. § 6662(d)(2)(B) (2000). Although "a taxpayer's position with respect to the tax treatment of an item that is arguable but fairly unlikely to prevail in court would satisfy a reasonable basis standard but not the substantial authority standard," the reverse will always be true—the stricter substantial authority standard will naturally satisfy the relaxed reasonable basis standard. *Norgaard*, 939 F.2d at 880.

92. Treas. Reg. § 1.6662-4(d)(3)(iii).

93. *See, e.g.*, I.R.C. § 6662(d)(2)(B); Stanford v. Comm'r, 152 F.3d 450, 460-61 (5th Cir. 1998); Treas. Reg. § 1.6664-4(b)(1) (as amended in 2003).

94. *See* 31 C.F.R. § 10.35(b)(4) (2006) (describing the "more likely than not" standard as "a greater than 50 percent likelihood" as applied to reliance opinions); s*ee also id.* § 10.35(e)(4) ("An opinion that does not reach a conclusion at a confidence level of at least more likely than not with respect to . . . significant Federal tax issues . . . cannot be used by the taxpayer, for the purpose of avoiding penalties . . . .").

95. I.R.C. § 7805(a) (2000).

96. BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 110.4.2, at 110-36 (2d ed. 1992).

Treasury to issue regulations.[97] As noted by the plain meaning of § 822 of the American Jobs Creation Act of 2004, Congress specifically authorized the Treasury to regulate written tax advice.[98] Thus, Circular 230 is a legislative regulation because it is issued pursuant to a specific grant of Congressional authority.[99]

A legislative regulation has the force of law "only if it is (1) within the granted power of the agency; (2) issued pursuant to proper procedure; and (3) reasonable."[100] The "proper procedure" for issuing legislative regulations is contained in the Administrative Procedure Act ("APA"), which mandates that the Treasury "(1) publish a notice of proposed rule making in the Federal Register; (2) give interested persons an opportunity to comment on the proposed rule; and (3) postpone the effective date of the rule until thirty days after publication in the Federal Register."[101] Furthermore,

> [t]he opportunity to comment [on proposed regulations] cannot be overstated because persons who may be subject to the [regulation] have the most at stake and may want to comment. Thus, the APA rightly provides these individuals (and the public at large) with an opportunity to be heard, and for their views to be considered.[102]

The Treasury issues both legislative and interpretive regulations pursuant to the APA's notice-and-comment procedures.[103] Paragraph 1 of Circular 230 confirms it is subject to the APA.[104]

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97. *Id.* at 110-35-36; *see e.g.*, I.R.C. § 6404(f)(3) (directing the Secretary of the Treasury to prescribe regulations necessary to effectuate the provision).

98. Pub. L. No. 108-357, § 822(b), 118 Stat. 1418, 1587 (to be codified as amended at 31 U.S.C. § 330).

99. *See e.g.*, 31 C.F.R. § 10.35(b)(4) (regulating written reliance opinions); *see* American Jobs Creation Act of 2004, § 822(b), 118 Stat. at 1587.

100. MICHAEL I. SALTZMAN, IRS PRACTICE & PROCEDURE ¶ 3.02[4][a], at 3-9 (2d ed. 1991); *see also* BITTKER & LOKKEN, *supra* note 96, ¶ 110.4.2, at 110-35-36 ("Legislative regulations . . . are often said to have the force of law because they entail an exercise of power delegated by Congress to the agency, as though it were a deputy legislature.").

101. SALTZMAN, *supra* note 100, ¶ 3.02[3], at 3-6 (citing 5 U.S.C. § 553(b)–(d)).

102. *See* Vasquez & Lowy, *supra* note 38, at 251-52; *see, e.g.*, ACLU v. FCC, 823 F.2d 1554, 1581 (D.C. Cir. 1987) ("Notice and comment rulemaking procedures obligate the FCC to respond to all significant comments, for 'the opportunity to comment is meaningless unless the agency responds to significant points raised by the public.'") (quoting Ala. Power Co. v. Costle, 636 F.2d 323, 384 (D.C. Cir. 1979)); Rodway v. USDA, 514 F.2d 809, 816-17 (D.C. Cir. 1975) (noting that the Secretary of Agriculture's later explanations regarding a basis and purpose statement under the APA could not "address comments never received").

103. *See* 5 U.S.C. § 553 (2000); SALTZMAN, *supra* note 100, ¶ 3.02[2], at 3-5-6 (describing the regulations process); *see also* BITTKER & LOKKEN, *supra* note 96, ¶ 110.4.1,

1. Practitioner Comments in Response to Proposed Circular 230

The Treasury technically complied with the literal language of the APA by issuing the Circular 230 regulations in proposed form (including current § 10.35(b)(4))[105] and seeking comments.[106] However, it failed to comply with the spirit of the APA by not addressing comments received regarding § 10.35(b)(4) of Circular 230. In response to the issuance of proposed Circular 230 in December 2003, a significant number of practitioners affected by the new regulations submitted written comments in opposition to § 10.35, as discussed below, but the Treasury completely ignored them. Relevant comments are set forth below:

a. Definitions

Lewis Steinberg, Chairman for the New York State Bar Association, stated on behalf of that organization that:

> We believe that the best way to address the legitimate concerns of the Treasury without unduly subjecting tax practitioners and their clients to excessive regulation is to exclude certain opinions (or communications not rising to the level of a traditional opinion) from the requirements of Circular 230. As a general proposition, such opinions or communications would not provide any protection from penalties.[107]

Regarding § 10.35, Requirements for Covered Opinions, Paul Cinquemani of the National Association of Tax Professionals expressed these ominous statements:

> This section caused us the most concern of any provisions in these proposed amendments.
>
> . . . .

at 110-34.

104. 31 C.F.R. pt. 10, ¶ 1 (2006) (listing 5 U.S.C. §§ 301, 500, 551-59 in the "Authority" section).

105. 68 Fed. Reg. 75,186, 75,189-90 (Dec. 30, 2003) (to be codified at 31 C.F.R. pt. 10).

106. *Id.* at 75,186.

107. Lewis R. Steinberg, *NYSBA Comments on Proposed Circular 230 Amendments*, TAX NOTES TODAY, Mar. 15, 2004, *available at* 2004 LEXIS TNT 58-46.

> We take issue . . . with the broad, open, all-inclusive definition of "tax shelter" as expressed in Section 10.35(c). . . . The definition proposed could conceivably include any transaction entered into by a taxpayer with the express objective of taking advantage of provisions in the law designed to enable the reduction or avoidance of taxes. Such unlimited exposure to an allegation of rendering a tax shelter opinion is unfair and contrary to the intent of law and our current system of taxation.[108]

Louis Mezzullo, Chairman of the American College of Tax Counsel, offered a proposed definition of "opinion" in opposition to the proposed "limited scope opinion" approach taken in the proposed regulations:

> Assuming that the definition of a "tax shelter" is not going to be narrowed, the ACTC believes that the scope of the application of Circular 230 can appropriately be limited by providing that the only opinions subject to section 10.35(a) of Circular 230 would be (i) marketed opinions, and (ii) opinions expressly issued for purposes of avoiding a penalty. The latter type of opinions, which are commonly referred to as "reliance opinions," would presumably state that they have been issued by a tax practitioner for purposes of establishing that a taxpayer reasonably believed that the tax treatment of the subject transaction was correct at a more likely than not (or higher) level of comfort.[109]

The American Institute of Certified Public Accountants expressed its concerns:

> The AICPA appreciates the difficulty that is inherent in defining the term "tax shelter." In this context, proposed section 10.35 retains the definition of tax shelter as originally proposed in January 2001 by utilizing "a significant purpose" test language of IRC section 6662(d)(2)(C)(iii). We continue, however, to believe that this language

108. Paul Cinquemani, *Proposed Tax Shelter Opinion Rules are Too Sweeping, NATP Says*, TAX NOTES TODAY, Mar. 11, 2004, *available at* 2004 LEXIS TNT 48-42.

109. Louis Mezzullo, *College of Tax Counsel Addresses Changes to Circular 230*, 102 TAX NOTES 1151, 1152 (2004), *available in* TAX NOTES TODAY, 2004 LEXIS TNT 41-52.

> (i.e., an entity, plan, or arrangement that has "a significant purpose" of which is the avoidance or evasion of Federal income tax) lacks clear definition, is overly-broad, and may result in inconsistent administration or enforcement of the regulations. Accordingly we urge the IRS to consider amending the proposed section 10.35(c)(2) definition of tax shelter in order to ensure that enforcement is focused on clear violations of the tax law and regulations, thereby providing less opportunity for inappropriate assertions of the application of the law or penalties against practitioners.[110]

Richard Shaw, Chairman of the ABA Section of Taxation, commented on behalf of that group regarding "more likely than not" tax shelter opinions:

> We agree with the approach of the proposal to impose the tax shelter opinion requirements on "more likely than not tax shelter opinions." Such opinions are assumed by investors to offer at least some level of penalty protection, even though absent compliance with the proposed requirements (that they address all material tax issues, relate the law to the actual facts, and draw an overall conclusion) they would offer little if any such protection. We caution, however, that absent a carefully drawn definition of "more likely than not tax shelter opinion" that excludes advice of an informal nature, the proposal could have unintended consequences, placing impossible burdens on traditional tax planning advice necessary to the functioning of our tax system, and deterring taxpayers from seeking advice they need.[111]

110. Am. Inst. of Certified Pub. Accountants, *AICPA Comments on Regs Regarding Changes to Circular 230*, TAX NOTES TODAY, Feb. 18, 2004, *available at* 2004 LEXIS TNT 32-29 (emphasis omitted).

111. Richard A. Shaw, *ABA Comments on Proposed Circular 230 Changes on Tax Shelters*, TAX NOTES TODAY, Feb. 18, 2004, *available at* 2004 LEXIS TNT 32-28.

b. Opt-out Procedure

Kenneth Horwitz of the law firm of Glast, Phillips & Murray urged IRS Chief Counsel Donald L. Korb to reconsider the enactment of the Circular 230 Regulations:

> The application of the covered opinion rules with an opt-out (not opt-in) procedure creates significant problems for tax lawyers and law firms, as well as for clients (that is, taxpayers). . . . [I]t is apparent to me that there is a serious disconnect between the understandings of the Treasury and IRS officials and the realities of the practice of law.
>
> . . . .
>
> The conclusion is that the Circular 230, and its recent amendment (i) do not reach the core of tax advice rendered by law firms, that is, advice in the context of transactions that have a significant purpose of tax avoidance (which is the bulk of all transactions of whatever nature), (ii) do not provide guidance of what is or is not a "significant purpose," and (iii) clearly apply the detailed rules of Circular 230 to practitioners who are not tax practitioners, including, for example, the divorce lawyer who may render an opinion on alimony or, the real estate lawyer who may send a client letters recommending use of a partnership versus an "S" corporation versus a limited liability company versus a disregarded entity, etc.[112]

Kenneth Gideon outlined several changes to the proposed Circular 230 regulations as recommended by the ABA Section of Taxation.[113] Among the items listed is the following regarding the practicalities of the required location and size of the opt-out legend proposed in § 10.35:

> Compliance with the regulations' requirement that many categories of written advice, no matter how informal, must bear a legend (in a type-face larger than any other used in the document)

112. Kenneth M. Horwitz, *Attorney Urges Reconsideration of Circular 230 Provisions*, TAX NOTES TODAY, June 3, 2005, *available at* 2005 LEXIS TNT 106-21.

113. *See* Kenneth W. Gideon, *ABA Members Seek Revisions, Delayed Implementation for Circular 230 Rules*, TAX NOTES TODAY, May 13, 2005, *available at* 2005 LEXIS TNT 92-17.

> stating that the advice may not be relied on for penalty-protection purposes will often be difficult (e.g., in a large-type slide presentation) and inadvertent non-compliance will likely be a frequent occurrence. The better solution would be to eliminate the legend requirement for informal advice and, instead, to amend Circular 230 and regulations under Code sections 6662 and 6664 to provide that an opinion may not be relied on for purposes of penalty protection unless the opinion states that such reliance is intended ("opt-in").[114]

Attorney Arthur L. Bailey of Steptoe & Johnson LLP suggested alternatives to improve the proposed Circular 230 regulations, echoing the suggestion that:

> The regulations should include an "opt in" for penalty avoidance purposes. . . . Practitioners and their clients may "opt in" to the covered opinion requirements for purposes of an opinion written and intended for penalty avoidance purposes. This modification parallels our recommendation that the [IRS] amend regulations governing the reasonable cause exception to require an opinion that satisfies section 10.35 . . . .[115]

Attorneys Jerald August and Guy Maxfield of the law firm Fox Rothschild LLP suggested an alternative to the proposed "opt-out" system:

> [T]he "opt-out" system . . . should be eliminated and replaced with an "opt-in approach." Subject to special exceptions for marketed opinions and listed and reportable transactions, a tax advisor should generally have the ability to "opt-in" and specifically provide a penalty protection type written opinion to a client that carries a banner that it is intended for such purpose.[116]

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114. *Id.* (emphasis omitted).

115. Arthur L. Bailey, *Attorney Suggests Alternatives to Improve Circular 230 Rules*, 107 TAX NOTES 1185, 1187 (2005), *available in* TAX NOTES TODAY, 2005 LEXIS TNT 88-100 (footnote and emphasis omitted).

116. Jerald D. August & Guy B. Maxfield, *Writers Seek Delay in Implementation of Circular 230 Rules*, TAX NOTES TODAY, May 12, 2005, *available at* 2005 LEXIS TNT 91-15.

Louis Mezullo also later wrote on behalf of the members of the American College of Tax Counsel and expressed their concern that the Circular 230 amendments were overly broad, encompassing some types of items that should not fall under § 10.35:

> Section 10.35 should be clarified that it does not apply to any written advice provided to a taxpayer after a transaction has closed or been implemented with respect to any audit, examination, appeals or litigation concerning the transaction. In addition, although a practitioner may not base advice on the possibility that a return may not be audited or that an issue may not be raised on audit, a practitioner should be able to discuss in writing with a client the audit practices of the [IRS] and the client's ability to contest or appeal an adverse determination by the [IRS].[117]

The Bond Market Association expressed its fears that the proposed Circular 230 regulations would disrupt the marketplace in member John Vogt's comments:

> [T]he disclosure and discussion of potentially significant Federal tax issues will substantially change the tax section of the offering materials, and will undoubtedly confuse and disrupt the marketplace. All but the most sophisticated investors will not understand the substance of the Federal tax issues being discussed, and all investors will be confused by the notion that bond counsel is giving an unqualified opinion in the presence of Federal tax issues being identified as potentially significant.[118]

c. Practitioner-Client Relationship

Edward Koren of the ABA Section of Real Property, Probate, and Trust Law expressed concern regarding the effect the Circular 230 regulations might have on the practitioner/client relationship:

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117. Louis Mezzullo, *College of Tax Counsel Criticizes Sweep of Circular 230 Amendments*, TAX NOTES TODAY, June 10, 2005, *available at* 2005 LEXIS TNT 111-18.

118. John Vogt, *Bond Market Association Attacks Circular 230 Regs.*, TAX NOTES TODAY, Mar. 11, 2005, *available at* 2005 LEXIS TNT 47-25.

> Clients will fear that they cannot rely on their practitioner to offer them advice without producing a document that is formalistic and expensive; or, in the alternative, that they cannot rely on the practitioner's advice due to the existence of the disclaimer language that is prominently displayed. These fears will result in a lack of confidence in the practitioner and the inevitable conclusion that such advice was written, whether as a covered opinion or with disclaimers, to protect the practitioner and not the client.[119]

Richard Lipton of Baker & McKenzie hypothesized that clients might face a new world of tax advice on June 21, 2005:

> Clients who want a one-page e-mail on a relatively non-controversial tax planning matter in a day would be more than displeased to learn that because of these rules, their one-page e-mail must be a three-pages opinion, will require two days (since the firm's policy requires another tax partner to review all opinions to ensure compliance), and will cost twice what it would have otherwise.[120]

Attorney James Peaslee urged the IRS to consider that client needs would not be met through the proposed changes to Circular 230:

> The covered opinion standards are written having in mind a penalty-protection opinion for a specific transaction. An opinion of that type may not be workable for a number of reasons. First, the advice may relate to groups of transactions or hypothetical transactions for which the requirements of the regulations could not realistically be met. . . . Second, the audience may not be tax lawyers or judges but rather business executives who want to understand tax risks in a transaction. They have no interest in reading pages of legal jargon in an opinion format. They also do not want to read about all potentially significant tax issues. They want their advisors to

119. Edward F. Koren, *ABA Section Members Comments on Circular 230 Regs.*, TAX NOTES TODAY, May 11, 2005, *available at* 2005 LEXIS TNT 90-23.

120. Lipton, *supra* note 6.

> serve as a filter, to tell them where the real risks are and how they can be addressed (including how a transaction could be planned or changed to minimize risks).[121]

Ronald Wiener, a tax practitioner of thirty-five years, commented that:

> In its presently proposed form, the burdensome requirements of section 10.35(a) would apply to a substantial proportion of written tax advice routinely provided by practitioners to their taxpayer-clients in contexts totally unrelated to the commonly understood concepts of "tax shelters." This is because of the combination of the extremely broad definition of "tax shelter" combined with the extremely broad definition of "tax shelter opinion" in applying the definition of "more likely than not tax shelter opinion" in proposed section 10.35(a).[122]

The problem was summed up succinctly by attorney James Richardson: "Our major concern is that if the client perceives that costs of [tax] advice are rising, or if simple preliminary tax discussions are littered with alarming disclaimers, the client may, to the detriment of all concerned, refrain from seeking the tax advice that it needs."[123] Richardson's sentiment echoed the comments expressed by the Association of the Bar of the City of New York submitted by its chairman, Ronni G. Davidowitz, who similarly said:

> There is substantial concern among the tax bar that the wide net cast by the [proposed r]egulations will restrict the normal flow of routine written tax advice from the lawyer to the client. As a result, some taxpayers will not obtain the timely and reasonably priced advice they have come to expect . . . . This is hardly the outcome

121. James M. Peaslee, *Attorney Seeks Improvements to Circular 230 Rules*, TAX NOTES TODAY, Mar. 9, 2005, *available at* 2005 LEXIS TNT 45-14.

122. Ronald M. Wiener, *Some Aspects of Proposed Amendments to Circular 230 Are Overbroad, Attorney Says*, TAX NOTES TODAY, Feb. 26, 2004, *available at* 2004 LEXIS TNT 38-32.

123. James R. Richardson, *Attorney Urges Clarification of Proposed Regs on State or Local Bond Opinions*, TAX NOTES TODAY, Apr. 1, 2005, *available at* 2005 LEXIS TNT 62-24.

> envisioned by issuance of the [proposed r]egulations.[124]

In addition to the comments listed above, the Treasury and IRS received many more comments that were critical of Circular 230.[125] These comments were not confined solely to the proposed amendments to Circular 230; a number of critical comments were received prior to the proposed amendments.[126]

B. *Treasury Response*

In December 2004, the Treasury responded to practitioner complaints about § 10.35(d)(4) by renumbering it to § 10.35(b)(4)(ii) and slightly changing its format.[127] Section 10.35(b)(4)(ii) provides as follows:

> For purposes of this section, written advice, other than advice described in paragraph

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124. KEVIN MATZ & RONNI G. DAVIDOWITZ, ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, COMMENTS ON CIRCULAR 230 REGULATIONS (2005), http://www.abcny.org/pdf/report/CommentsCircular230Regulations.pdf.

125. *See, e.g.*, Keith D. Lawson, *Attorney Seeks Exemption of Municipal Bonds from Tax Shelter Opinion Standards*, TAX NOTES TODAY, Mar. 11, 2004, *available at* 2004 LEXIS TNT 48-43 (retain municipal bond exception); John O. Swendseid, *Attorney Addresses Exempt Bond Issues Under Proposed Circular 230 Changes*, TAX NOTES TODAY, Mar. 10, 2004, *available at* 2004 LEXIS TNT 47-45 (same); Judith P. Zelisko, *TEI Praises Government for Revisions to Circular 230 Written Opinion Standards*, TAX NOTES TODAY, June 6, 2005, *available at* 2005 LEXIS TNT 107-17 (applauding May 2005 final regulations amending Circular 230 which place in-house tax professionals in a separate category); Judith P. Zelisko, *TEI Suggests Changes to Circular 230 Rules*, 107 TAX NOTES 1183, 1183 (2005), *available in* 2005 LEXIS TNT 91-16 (in-house tax professionals); Letter from John Vogt, Executive Vice President, The Bond Mkt. Ass'n, to Internal Revenue Serv. (Feb. 13, 2004), *available at* http://www.bondmarkets.com/regulatory/ltr_to_irs_proposed_amend_treas_circular_230-021304.pdf (urging municipal bond clarification).

126. *See e.g.*, Robert L. Ashby, *TEI Recommends Changes to Circular 230 Regs*, TAX NOTES TODAY, Mar. 8, 2002, *available at* 2002 LEXIS TNT 46-25 (in-house tax professionals); N. Jerold Cohen, *Writer Suggests Changes to Proposed Circular 230 Regs*, TAX NOTES TODAY, May 31, 2001, *available at* 2001 LEXIS TNT 105-29 (conflicts of interest); Lawrence M. Hill, *Attorney Recommends Changes to Proposed Circular 230 Regs*, TAX NOTES TODAY, Apr. 18, 2001, *available at* 2001 LEXIS TNT 75-22 (compliance costs); David A. Lifson, *AICPA Suggests Changes to Circular 230*, TAX NOTES TODAY, July 20, 2000, *available at* 2000 LEXIS TNT 140-16 (definition and regulation of tax shelters); Richard M. Lipton, *ABA Tax Section Suggest Shelter Revisions to Circular 230 Proposed Regs.*, TAX NOTES TODAY, May 6, 2002, *available at* 2002 LEXIS TNT 87-21 (31 C.F.R. §§ 10.33, 10.35); Richard M. Lipton & Frederic L. Ballard, Jr., *ABA Tax Section Offers Definition of 'Tax Shelter' for Circular 230 Regs.*, TAX NOTES TODAY, Aug. 15, 2001, *available at* 2001 LEXIS TNT 158-15 (definition of "tax shelter"); Pamela F. Olson, *ABA Tax Section Suggests Circular 230 Changes*, TAX NOTES TODAY, Sept. 21, 2000, *available at* 2000 LEXIS TNT 184-19 ("pre-opinion opinions"); Pamela J. Pecarich, *AICPA Suggests Changes to Proposed Regs on Tax Shelter Opinions*, TAX NOTES TODAY, Feb. 19, 2002, *available at* 2002 LEXIS TNT 33-72 (definition of "tax shelter").

127. *See* 69 Fed. Reg. 75,839 (Dec. 20, 2004) (to be codified at 31 C.F.R. pt. 10).

> (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion), is not treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.[128]

Accordingly, beyond renumbering and slightly changing the format, the regulation remained virtually identical following the commentary period, implying that the Treasury ignored the comments by those most affected by the regulation. By ignoring such comments, the Treasury violated the spirit of the APA and rendered the "notice-and-comment" process meaningless. As aptly noted by the Court of Appeals for the D.C. Circuit in *Alabama Power Co. v. Costle*, "the opportunity to comment is meaningless unless the agency responds to significant points raised by the public."[129]

## VI. SECTION 10.35(b)(4)(ii) OF CIRCULAR 230 RESULTS IN DISPARATE TREATMENT OF SIMILARLY SITUATED TAXPAYERS

The administration of our tax system, specifically the imposition of accuracy-related penalties against taxpayers, demands uniformity of treatment among similarly situated taxpayers.[130] In January 2007, the district court for the Eastern District of Texas confirmed the viability of relying on a tax advisor's oral advice to avoid the imposition of accuracy-related penalties in *Klamath Strategic Investment Fund, LLC v. United*

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128. 31 C.F.R. § 10.35(b)(4)(ii) (2006) (emphasis omitted).

129. 636 F.2d 323, 384 (D.C. Cir. 1979) (quoting Home Box Office, Inc. v. FCC, 567 F.2d 9, 35-36 (D.C. Cir. 1977)); *see also* ACLU v. FCC, 823 F.2d 1554, 1582 (D.C. Cir. 1987) ("[T]he obligation to respond to significant comments represents the legally enforceable minimum."); *Home Box Office*, 567 F.2d at 35 n.58 ("[O]nly comments which, if true, raise points relevant to the agency's decision *and which, if adopted, would require a change in an agency's proposed rule* cast doubt on the reasonableness of a position taken by the agency [that a comment is not significant].") (emphasis added); Rodway v. U.S. Dep't of Agric., 514 F.2d 809, 817 (D.C. Cir. 1975) ("The basis and purpose statement is not intended to be an abstract explanation addressed to imaginary complaints. Rather, its purpose is, at least in part, to respond in a reasoned manner to the comments received, to explain how the agency resolved any significant problems raised by the comments, and to show how that resolution led the agency to the ultimate rule.").

130. *See, e.g.*, Computer Scis. Corp. v. United States, 50 Fed. Cl. 388, 393 (2001); *see also* cases cited *infra* note 135.

*States*.[131] The court concluded that the transaction at issue lacked economic substance, yet upheld the reasonable cause defense to penalties based in part on oral advice received by the taxpayer.[132] This decision not only affirmed that taxpayers can rely on oral advice to avoid penalties, it also nicely "tees up" the problems with § 10.35(b)(4)(ii) of Circular 230.[133]

To illustrate with a hypothetical set of facts: Client A receives a "reasonable basis" oral opinion from a tax practitioner regarding a potential transaction. Client B receives the same "reasonable basis" opinion from the same tax practitioner regarding the same potential transaction but in the written form of an e-mail. The tax practitioner complies with § 10.35(b)(4)(ii) and includes a "no reliance" legend in his e-mail. He is also aware of all relevant facts relating to the potential transaction.

Under these facts, if the IRS disallows deductions or credits with respect to the transaction and tries to impose accuracy-related penalties against Clients A and B, it will likely only be successful in imposing the penalty against Client B. The reason is simple and clear—the "no reliance" legend. How consistent and uniform is it if Client A can receive a "reasonable basis" oral opinion from the tax practitioner regarding a transaction that qualifies for avoidance of penalties, but Client B is liable for penalties on almost the exact same facts? The only difference is that Client B received his "reasonable basis" opinion in an e-mail containing Circular 230's "no reliance" legend. "[T]axpayers have a legal right to uniform interpretation of the laws . . . ."[134] Accordingly, § 10.35(b)(4)(ii) in practice will result in a distinction between similarly situated taxpayers, which constitutes inappropriate disparate treatment by the Treasury and IRS. As pertinently noted by the Court of Federal Claims in *Computer Sciences Corp. v. United States*, "[o]ne situation in which the Commissioner's actions may constitute an abuse of discretion is when similarly-situated taxpayers are treated differently without a rational basis for the disparate treatment."[135]

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131. 472 F. Supp 2d 885, 905 (E.D. Tex. Jan. 31, 2007) (mem.).

132. *Id.*

133. *See id.*; 31 C.F.R. § 10.35(b)(4)(ii).

134. Bunce v. United States, 28 Fed. Cl. 500, 509 (1993).

135. *Computer Scis. Corp.*, 50 Fed. Cl. at 393; *see also* United States v. Kaiser, 363 U.S. 299, 308 (1960) (Frankfurter, J., concurring) ("The Commissioner cannot tax one and not tax another without some rational basis for the difference."); Auto. Club of Mich. v. Comm'r, 353 U.S. 180, 184 (1957) (IRS discretion is limited "to the extent necessary to avoid inequitable results"); Powell v. United States, 945 F.2d 374, 378 (11th Cir. 1991) ("The IRS is not allowed to treat two similarly situated taxpayers differently."); Ogiony v. Comm'r, 617 F.2d 14, 18 (2d Cir. 1980) ("[C]onsistency over time and uniformity of

If the Treasury's disparate treatment of similarly situated taxpayers is not remedied, tax practitioners and their clients may have to rely on oral tax advice to avoid the imposition of penalties. A system in which clients take ever-so-copious notes and tax practitioners heavily document a file to confirm the advice provided in an effort to avoid sending written correspondence to the client is not an efficient administration of our tax system. Our tax system should strive to avoid the following outcome recently predicted by commentator Joe Walsh: "Circular 230 might have as one of its main unintended consequences the revival of the ancient art of stenography."[136]

## VII. SECTION 10.35(b)(4)(ii) IS OVERBROAD

Rather than stopping at listed transactions and tax shelters, the Treasury's decision to lump all routine written tax advice into the same "no reliance" disclaimer requirement is overbroad. "Federal regulation in the form of clear rules targeted at potential abuse is one thing. To require heightened standards for essentially all written tax advice as Circular 230 does, however, is another."[137] The burdens imposed on tax practitioners and their clients by section 10.35(b)(4)(ii) are beyond the realm of reasonable and do not compare to any burdens outside of the tax arena.[138]

Since the inception of § 10.35, IRS officials have given the impression that the literal language of § 10.35 is not what will control. Then-OPR Director Namorato stated publicly that an "off-the-cuff" one line e-mail response is not the kind of written advice the IRS is targeting.[139] Namorato also stated that items such as handouts, and impliedly outlines and articles, would not qualify as § 10.35 marketed opinions any more than would a "practitioner's Valentine's Day card to his spouse."[140] In an attempt to allay practitioner concerns regarding Circular 230, IRS Chief Counsel Donald Korb advised tax practitioners to "take a deep breath and read the rules. . . . It's our objective here to

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treatment among taxpayers are proper benchmarks from which to judge IRS actions."); IBM v. United States, 343 F.2d 914, 920 (Ct. Cl. 1965) ("Equality of treatment is . . . dominant in our understanding of justice . . . .").

136. Joe Walsh, *Circular 230 Sets Stringent Requirements for Written Tax Advice*, 75 PRAC. TAX STRATEGIES 196, 211 (2005).

137. Paravano & Reynolds, *supra* note 40, at 341.

138. *Id.*

139. Sheryl Stratton, *Common Sense Urged by IRS at Circular 230 Program*, TAX NOTES TODAY, May 11, 2005, *available at* 2005 LEXIS TNT 90-3.

140. Sheryl Stratton, *Circular 230 Changes Fall Short of Expectations*, TAX NOTES TODAY, May 19, 2005, *available at* TAX NOTES TODAY, 2005 LEXIS TNT 96-1.

apply common sense."[141] Eric Solomon, Treasury deputy assistant secretary of regulatory affairs, stated that Circular 230 was generally aimed at "fringe behavior involving scams and schemes."[142]

As aptly stated by some commentators regarding IRS officials' comments:

> Statements by government officials that tax advisors should take comfort in the fact that the Circular 230 rules will be enforced in a "reasonable" rather than a literal manner are appreciated but also create a certain amount of horror in the minds of tax practitioners who feel compelled to attempt to comply with the laws as written. If a regulation cannot be or will not be enforced pursuant to its terms, the regulation should be changed.[143]

The Treasury has been restrained by courts from applying a regulation in an inconsistent manner from which the regulation was written.[144] For example, in *Woods v. Commissioner*, the taxpayer argued for a literal interpretation of the consolidated return regulations, and the Tax Court agreed.[145] In that case, the consolidated regulation in question, a 1966 version of Treasury Regulation § 1.1502-32, was promulgated by the Treasury pursuant to legislative mandate.[146] From 1966 until 1982, the IRS interpreted the regulation in a way favorable to the taxpayer.[147] In 1982, however, the IRS changed its

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141. Allen Kenney, *Korb: Use Common Sense When It Comes to Circular 230*, TAX NOTES TODAY, June 21, 2005, *available at* 2005 LEXIS TNT 118-6.

142. Sheryl Stratton, *Tension Mounts over Opinion Standards Regs as Effective Date Draws Near*, TAX NOTES TODAY, April 20, 2005, *available at* 2005 LEXIS TNT 75-4 (internal punctuation omitted).

143. Paravano & Reynolds, *supra* note 40, at 341-42.

144. *See* George L. White, BNA Tax Management Portfolios 754-3rd T.M., Consolidated Returns—Elections and Filing, A5 (2005).

145. Woods Inv. Co. v. Comm'r, 85 T.C. 274, 281-82 (1985), *acq.*, 1986-2 C.B.1, *available at* 1986 WL 713546.

146. *Id.* at 277-78. The court quoted then I.R.C. § 1502, describing the Treasury's broad regulation authority under consolidated return:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return . . . may be returned, determined, computed, assessed, collected, and adjusted, in such manner as to clearly reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

*Id.* at 277 (quoting I.R.C. §1502 (1954)).

147. *See id.* at 280-81.

interpretation of the regulation, without amending it, to combat the taxpayer's "double deduction."[148] The Tax Court rejected this change of interpretation, stating that the IRS is bound by the regulations as written.[149] Quite commonsensically, the court reasoned that if the Treasury would like to avoid a "double deduction" situation, the IRS Commissioner should "use his broad power to amend his regulations."[150]

As previously discussed, § 10.35 as written is overbroad. Although a legislative regulation is awarded a significant level of deference,[151] the Treasury is still bound by the "regulations as written."[152] If the Treasury intends to narrow this regulation's scope to a "common sense" test,[153] it should amend the regulation to define what that test means. Such a move is certainly within the Treasury's "broad power" and will inevitably avoid many unfortunate situations where the taxpayers rely on the "regulations as written."

## VIII. SECTION 10.35(b)(4)(ii) MAY VIOLATE THE FIRST AMENDMENT

Section 10.35(b)(4)(ii) of Circular 230 may also violate the First Amendment of the U.S. Constitution because the section in part inhibits the free flow of certain information between the tax

148. *See id.* at 281 (discussing double deductions and concluding that "[i]n 1982, although [the Commissioner] changed his position to the one he advances herein, he failed to amend his regulations to reflect his new position").

149. *Id.* at 281-82.

150. *Id.* at 282; *see also* IU Int'l Corp. v. United States, 34 Fed. Cl. 767, 772 (1996) (characterizing the *Woods* case: "the Commissioner is held to the effect of conflicting regulations that it could have corrected").

151. *See* United States v. Mead, 533 U.S. 218, 227-28 (2001); Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 865 (1984); McKnight v. Comm'r, 7 F.3d 447, 450-51 (5th Cir. 1993) (giving legislative regulations *Chevron* deference and interpretative regulations *National Muffler* deference); Dresser Indus., Inc. v. Comm'r, 911 F.2d 1128, 1137-38 (5th Cir. 1990) ("Regulations 'issued under a specific grant of authority' . . . are to be accorded more weight than those promulgated under a more general authority. . . . The latter category of regulations, sometimes characterized as 'interpretive,' must 'harmonize[] with the plain language of the statute, its origin, and its purpose.'") (quoting Rowan Cos. v. United States, 452 U.S. 247, 253 (1981)); City of Tucson v. Comm'r, 820 F.2d 1283, 1287 (D.C. Cir. 1987) ("A treasury regulation commands significant judicial deference . . . especially when, as here, the statute so construed . . . contains an express grant of rulemaking power."); Pac. First Fed. Sav. Bank v. Comm'r, 94 T.C. 101, 106 (1990), *rev'd*, 961 F.2d 800 (9th Cir. 1992) ("[W]hile the challenged provisions are entitled to deference, they are not entitled to as much deference as that owed to 'legislative regulations,' which are promulgated under more specific grants of authority.").

152. *Woods*, 85 T.C. at 282.

153. *See* Kenney, *supra* note 141.

professional and the client.[154] Such communication has been referred to as "commercial speech," which is entitled to limited First Amendment protection.[155]

Although the outer bounds of "commercial speech" are somewhat unclear,[156] the Supreme Court has offered a few guidelines. For example, in *Zauderer v. Office of Disciplinary Counsel of the Supreme Court of Ohio*, the Court favored a "common sense" approach to distinguishing between commercial speech and "other varieties of speech."[157] While not a hard and fast test, the Court did find in *Zauderer* that an attorney's newspaper advertisements constituted commercial speech.[158]

"Commercial speech" should be distinguished from "noncommercial speech," which is allowed somewhat greater protection under the First Amendment.[159] Nonetheless, a government mandated disclosure between a professional and a client is valid only "in the service of a substantial governmental interest, and only through means that directly advance that interest."[160] In *Zauderer*, the Supreme Court held that a state law requiring that attorney advertisements for contingent-fee arrangements contain a disclosure explaining some of the inherent legal risks did not violate the First Amendment because of the state's interest in preventing consumer deception.[161]

Applying this logic to a § 10.35 communication, and assuming that communication constitutes commercial speech, the Treasury is allowed to narrowly mandate a disclosure where it is reasonably related to a valid Treasury interest. As in *Zauderer*, the government interest behind § 10.35(b)(4)(ii) is to prevent deception (in this case, of the Treasury) through means of a disclaimer. Specifically, the Treasury sought "to battle abusive tax avoidance transactions and to rein in practitioners who disregard their ethical obligations," and one of the means to achieve it was to create minimum standards for advice by practitioners.[162] Arguably § 10.35's requirement that a reliance

154. *Compare* 31 C.F.R. § 10.35(b)(4)(ii) (2006) (requiring a disclosure statement for written tax advice not to be treated as a "reliance opinion"), *with* U.S. CONST. amend. I ("Congress shall make no law . . . abridging the freedom of speech . . . .").

155. *See, e.g.*, Moldenhauer, *supra* note 4, at 892-94 (discussing generally attorney opinions ("professional speech") and their relation to the commercial speech doctrine).

156. *Id.* at 893.

157. 471 U.S. 626, 637 (1985).

158. *Id.*

159. *Id.*

160. *Id.* at 638.

161. *Id.* at 651-53.

162. I.R.S. News Release IR-2004-152 (Dec. 17, 2004), *available at* http://www.irs.gov/irs/article/0,,id=132445,00.html.

opinion be at a "more likely than not" standard or disclaim penalty protection[163] is not reasonably related to the Treasury's interest in preventing deception. That is, a "more likely than not" threshold is unnecessarily high for obtaining a Congressionally-mandated comfort level of "reasonable."[164] Therefore, the Treasury's "more likely than not" threshold is unreasonable and does not properly advance its interest.

The First Amendment also prohibits certain restrictions on a professional's ability to provide advice to clients.[165] As mentioned above, reliance opinions require a "more likely than not" threshold or a "no reliance" disclaimer.[166] In mandating that the opinion fall into one of these two categories, the Treasury constructively limits the attorney from providing all written advice to a client. In other words, on certain issues, an attorney is prevented from offering written advice which may be relevant and helpful to the client's cause but does not meet the Treasury's high threshold.

It should be noted that in *Joslin v. Secretary of the Department of Treasury*, the district court held that former § 10.33 was not an abridgement of a tax attorney's "constitutionally protected speech but [was a] regulation[] governing the standard practice of professionals."[167] The court reasoned that the regulations were only required to satisfy guidelines for restriction of "false or misleading commercial speech."[168] However, the decision was later vacated by the 10th Circuit for lack of subject matter jurisdiction.[169] In addition, former § 10.33 related exclusively to tax shelter opinions, not *all* written tax advice, and was expressly drafted to conform with guidance issued by the ABA.[170]

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163. 31 C.F.R. § 10.35(b)(4) (2006).

164. *See* I.R.C. § 6664(c) (West 2000 & Supp. 2006).

165. *See* Legal Servs. Corp. v. Velazquez, 531 U.S. 533, 544 (2001) ("Restricting . . . attorneys in advising their clients and in presenting arguments and analyses to the courts distorts the legal system by altering the traditional role of the attorneys . . . ."); *see also* Conant v. Walters, 309 F.3d 629, 638 (9th Cir. 2002) (noting the similarity to *Velazquez* in that the government's policy restricting physicians from recommending marijuana to patients "alter[s] the traditional role of medical professionals by prohibit[ing] speech necessary to the proper functioning of those systems") (internal quotation marks omitted).

166. *See supra* note 163 and accompanying text.

167. 616 F. Supp. 1023, 1027 (D. Utah 1985) (mem.), *vacated*, 832 F.2d 132 (10th Cir. 1987).

168. *Id*.

169. Joslin v. Sec'y of the Dep't of the Treasury, 832 F.2d 132, 136 (10th Cir. 1987).

170. *See* 31 C.F.R. § 10.33 (1984) (amended by T.D. 9165, 2005-1 C.B. 357, 359); *supra* notes 32-35 and accompanying text.

## IX. SOME ARGUE CIRCULAR 230 VIOLATES FEDERALISM

The Tenth Amendment to the United States Constitution states: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."[171] Until the Supreme Court's 1992 decision in *New York v. United States*,[172] the Court had only found one violation of the Tenth Amendment since 1937, a span of fifty-five years.[173] In *New York*, the Court invalidated § 5(d)(2)(C) of the 1985 Low-Level Radioactive Waste Policy Amendments Act,[174] which required a state to either "take title" to the property in question or implement the federal program.[175] The Court reasoned that under the Tenth Amendment "[t]he Federal Government may not compel the States to enact or administer a federal regulatory program."[176]

Although § 10.35(b)(4) does not expressly compel the states to implement higher standards for opinions,[177] the provision is arguably a constructive federal program. That is, when an attorney offers advice on a transaction that contains both federal and state tax consequences, the advice must necessarily be structured to comply with this federal provision.[178] Such additional compliance on the federal side may burden the state tax advice in the form of poorer tax advice if the client, like many clients, is budget-conscious. In addition to creating traps for the unwary, poor tax planning may also cause states to lose tax revenue through lower compliance and lack of business interest as a result of such traps. Therefore, § 10.35(b)(4) possibly compels states to implement a constructive federal program adverse to states' interests and in violation of the Tenth Amendment.

Another federalism concern debatably disturbed by the provision is state sovereignty. As the Supreme Court explained in *New York*, the Constitution "leaves to the several States a residuary and inviolable sovereignty."[179] Arguably, § 10.35(b)(4)

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171. U.S. CONST. amend. X.

172. 505 U.S. 144 (1992).

173. ERWIN CHEMERINSKY, CONSTITUTIONAL LAW PRINCIPLES AND POLICIES § 3.9 (3d ed. 2006) (referencing Nat'l League of Cities v. Usery, 426 U.S. 833 (1976), *overruled by* Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528 (1985)).

174. Pub. L. No. 99-240, § 5(d)(2)(C), 99 Stat. 1842, 1850 (codified as amended at 42 U.S.C. § 2021e(d)(2)(C) (2000)).

175. *New York*, 505 U.S. at 187-88.

176. *Id.* at 188.

177. *See* 31 C.F.R. § 10.35(b)(4) (2006).

178. *See id.*

179. *New York*, 505 U.S. at 188 (quoting THE FEDERALIST NO. 39, at 245 (James

impedes upon state sovereignty when the provision attempts to regulate a state's own attorneys. As the states have regulated the practice of law for more than two centuries,[180] the Treasury may want to consider whether its broad interpretation of Congress's intent may be disturbing a delicate Federalism balance. Specifically, some argue that "[t]he new rules are so broad that they seem to completely abdicate state regulation of the practice of tax law."[181] Of course, in spite of federalism concerns, Congress may "pre-empt state regulation [that is] contrary to federal interests"[182] if Congressional intent is present[183] and clear.[184]

As previously discussed, Congress's principal purpose behind § 822 of the American Jobs Creation Act of 2004 was arguably to stem tax shelter activity.[185] As the enforcement arm of Congress for this particular provision,[186] the IRS is tasked with legislating based on Congress's intent.[187] If Congress's clear principal purpose under this provision was to stem tax shelter activity, the Treasury is not on solid ground for implementing § 10.35(b)(4)(ii) which, as enacted, applies to all written tax advice. In other words, if the IRS is not sure that Congress intended to cover transactions beyond tax shelter activity under the heightened standards, then § 10.35(b)(4)(ii) may not be a valid preemption regulation. Analyzed another way, for Congress to validly preempt a state's authority, a state regulation must be "contrary to a federal interest" and Congress's intent must be clear.[188] A Congressional mandate that supersedes a state's regulatory authority to control attorney involvement in tax shelter activity is arguably a valid preemption because the mandate aids federal

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Madison) (Clinton Rossiter ed., 1961)).

180. Paravano & Reynolds, *supra* note 40, at 341.

181. *Id.*

182. *New York*, 505 U.S. at 188.

183. Lorillard Tobacco Co. v. Reilly, 533 U.S. 525, 541 (2001) (advancing Congressional purpose as the "ultimate touchstone" in a preemption analysis).

184. Medtronic, Inc. v. Lohr, 518 U.S. 470, 485 (1996) ("In all pre-emption cases, and particularly in those in which Congress has legislated . . . in a field which the States have traditionally occupied, we start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.") (citation and internal quotation marks omitted).

185. *See supra* text accompanying notes 39-40.

186. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 822(b), 118 Stat. 1418, 1587 (delegating authority to the Secretary of the Treasury "to impose standards applicable to the rendering of written advice . . . which is of a type the Secretary determines as having a potential for tax avoidance or evasion").

187. Congress must, however, provide Treasury with "intelligible principles." Whitman v. Am. Trucking Ass'ns, Inc., 531 U.S. 457, 472 (2001).

188. *See supra* notes 182-84 and accompanying text.

interests. However, where Congress has not clearly intended for transactions outside of tax shelter activity to be included in the heightened provisions, the IRS may be overstepping preemption privileges.

## X. CONCLUSION

Section 10.35(b)(4)(ii) should be invalidated or entitled to little or no deference. Given the many shortcomings of § 10.35(b)(4)(ii) noted above, Circular 230 should join the litany of legislative regulations that have been invalidated by courts.[189] The Treasury's failure to comply with the spirit of the APA's notice-and-comment procedures could be sufficient cause to invalidate the regulation.[190] The Supreme Court and Tax Court have expressed the clearest views on when a regulation deserves to be invalidated. In *United States v. Cartwright*, the Supreme Court invalidated Treas. Reg. § 20.2031-8(b), noting:

> Congress surely could not have intended [I.R.C] § 2031 to be interpreted in such a manner. The Regulation also imposes an unreasonable and unrealistic measure of value. We agree with Judge Tannenwald [of the Tax Court], who stated . . . that "it does not follow that, because [the Commissioner] has a choice of alternatives, his choice should be sustained where the alternative chosen is unrealistic. In such a situation the

189. *See, e.g.*, Rite Aid Corp. v. United States, 255 F.3d 1357, 1359-60 (Fed. Cir. 2001) (invalidating Treas. Reg. § 1.1502-20); City of Tuscon v. Comm'r, 820 F.2d 1283, 1284-85 (D.C. Cir. 1987) (invalidating Treas. Reg. § 1.103-13(g)); Goodson-Todman Enters. v. Comm'r, 784 F.2d 66, 77 (2d Cir. 1986) (invalidating Treas. Reg. § 1.48-8(a)(3)(iii) as applied to "game shows"); Nat'l Westminster Bank, PLC v. United States, 44 Fed. Cl. 120, 131 (1999) (invalidating Treas. Reg. § 1.882-5); Phillips Petroleum Co. v. Comm'r, 97 T.C. 30, 36 (1991) (invalidating Treas. Reg. § 1.863-1(b)), *aff'd*, 70 F.3d 1282 (10th Cir. 1995) (unpublished table decision).

190. *See, e.g.*, Reeder v. FCC, 865 F.2d 1298, 1304 (D.C. Cir. 1989) (remanding on recognition that the FCC did not follow APA notice and comment requirements); Fla. Fruit & Vegetable Ass'n v. Brock, 771 F.2d 1455, 1460 (11th Cir. 1985) (invalidating 20 C.F.R. § 655.207(c) for failure to provide "adequate notice and opportunity to comment"); Am. Standard, Inc. v. United States, 602 F.2d 256, 269 (Ct. Cl. 1979) (invalidating part of Treas. Reg. § 1.1502-25(c) as "in violation of the delegation of rulemaking power and of the notice requirement of the Administrative Procedure Act"); *cf.* Chrysler Corp. v. Brown, 441 U.S. 281, 315-16 (1979) (invalidating labor regulations "not properly promulgated as substantive rules" because they "were essentially treated as interpretative rules and interested parties were not afforded the notice of proposed rulemaking required for substantive rules under [the APA]. . . . '[A] court is not required to give effect to an interpretive regulation.'") (second alteration in original) (quoting Batterton v. Francis, 432 U.S. 416, 425 n.9 (1977)).

> regulations embodying that choice should be held to be unreasonable."[191]

In *Rowan Cos. v. United States*, the Supreme Court invalidated Treas. Regs. §§ 31.3121(a)-1(f) and 31.3306(b)-1(f) for "fail[ure] to implement the congressional mandate in a consistent and reasonable manner."[192] In *United States v. Vogel Fertilizer Co.*, the Supreme Court invalidated Treas. Reg. § 1.1563-1(a)(3), which defined the term "brother-sister controlled group," as an unreasonable interpretation of I.R.C. § 1563(a)(2)(A).[193] In *City of Tucson v. Commissioner*, the D.C. Circuit concluded that because Treas. Reg. § 1.103-13(g) "stretches the language of [I.R.C. §] 103(c)(2)(B) beyond the breaking point, we cannot sustain it as an authorized implementation thereof."[194] The D.C. Circuit noted that the Treasury had "forged, not a reasonable implementation of the legislative mandate, but rather an impermissible enlargement by an unnatural construction of the statutory language."[195] In *Tate & Lyle, Inc. v. Commissioner*, the Tax Court invalidated part of Treas. Reg. § 1.267(a)-3 as "manifestly beyond the mandate of the statutory authorization."[196]

Surely Congress did not intend for the Treasury to treat written advice and oral advice in such a way that results in disparate treatment of taxpayers. In addition, Congress has expressed no intent to legislatively rescind the reasonable cause exception to penalties set forth in IRC § 6664(c). Because § 1035(b)(4)(ii) is a legislative regulation, it is entitled to more deference than what is afforded an interpretive regulation.[197] However, that section has failed to implement the Congressional mandate in a consistent and reasonable manner.

Circular 230's recent expansion, through § 10.35(b)(4)(ii), is a troubling misstep in the regulation of tax practitioners. The regulation eviscerates the plain meaning of the Internal Revenue Code, well established case law and agency regulation, sidesteps

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191. 411 U.S. 546, 557 (1973) (first alteration added) (quoting Estate of Wells v. Comm'r, 50 T.C. 871, 878 (1968) (Tannenwald, J., dissenting)).

192. 452 U.S. 247, 253 (1981).

193. 455 U.S. 16, 19, 21-22 (1982).

194. *City of Tucson*, 820 F.2d at 1290. Other circuit courts have also invalidated Treasury Regulations. *See, e.g.*, Nalle v. Comm'r, 997 F.2d 1134, 1140 (5th Cir. 1993) (invalidating Treas. Reg. § 1.48-12(b)(5)); Iglesias v. United States, 848 F.2d 362, 367 (2d Cir. 1988) (invalidating Treas. Reg. § 1.861-2(a)(1)); Estate of Gresham v. Comm'r, 752 F.2d 518, 521-22 (10th Cir. 1985) (invalidating Treas. Reg. 1.57-1(f)(3)).

195. *City of Tucson*, 820 F.2d at 1290.

196. 103 T.C. 656, 671 (1994).

197. *See* cases cited *supra* note 151.

the Administrative Procedure Act, treats similarly situated taxpayers inequitably, is overbroad, and is contrary to First Amendment and Federalism concerns. As such, Circular 230 should be invalidated, or at a minimum, entitled to little or no deference.

If practitioners and taxpayers seeking written tax advice are frustrated by § 10.35(b)(4)(ii), perhaps the following song performed on April 19, 2007 at the Tax Court Judicial Conference will provide comfort:

**Revolution #10.35**
**An Ode to IRS Circular 230,**
**Regulation of Federal Tax Opinion Practice**
*To the tune of The Beatles' "Revolution"*

You want a tax deferred transaction, well, you know
I think I could find a way
From penalties you want protection, well, you know
That's gonna change the price you pay
A covered opinion the way that the rules allow
Will probably cost an additional hundred thou

Don't you know it's gonna be, all right
If you can't take the penalty, it's all right
But the fee is gonna be, out of sight

My practice is now regulated, and, you know
I don't wanna go to jail
Last year I was investigated, well, you know
For leaving legends off my e-mail
Losing my license to practice would not be cool
Brother, I got seven children in private school

Don't you know it's gonna be, all right
If you can't take the penalty, it's all right
But the fee is gonna be, out of sight

[Instrumental]

I need this list of representations, 'cause, you know
I gotta ascertain the facts

Then I do investigations, 'cause, you know
I gotta cover my own ass
You want a quick email or tax advice on the phone
All I can tell you is, brother, you're on your own

[Refrain and out][198]

198. Song performed on April 19, 2007 by The Benchwarmers. Parody lyrics composed by Bill Wilkins. Source is on file with the authors.