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Author
Ventry, Dennis J

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The Reaction to the 1980 Proposed Amendments to Circular 230

By Dennis J. Ventry Jr.

Dennis J. Ventry Jr. is a visiting scholar in taxation at the UCLA School of Law and an assistant professor of law at the American University Washington College of Law (beginning fall 2006).

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I. Breaking Down the Proposed Amendments

On September 4, 1980, the Treasury Department released proposed amendments to federal regulations governing practice before the IRS. Amended Circular 230 set new standards for legal opinions used in the promotion of tax shelters. Treasury reported that it had identified 7,000 new shelter schemes since January 1980 and that lost revenue from abusive tax shelters had gone over $5 billion.[1] That widespread noncompliance threatened to undermine the public's confidence in the fairness of the tax system and, in turn, the self-assessment component of the federal income tax. Echoing earlier comments from IRS Commissioner Jerome Kurtz and Treasury General Counsel Robert Mundheim,[2] the proposed amendments noted the ''critical element'' of the tax lawyer's opinion in the promotion of abusive shelters. It also recited Treasury's earlier typology of four particularly troublesome opinions: (1) the intentionally false or incompetent opinion; (2) the opinion that relied on factual representations of the promoter even when some critical facts were questionable given other facts and circumstances of the transaction; (3) the opinion that never offered a conclusion on the tax aspects of the shelter offering; and (4) the ''reasonable basis'' opinion that may or may not have indicated a tax position's low likelihood of success.

The 1980 amendments added new section 10.51(j), which treated as an instance of disreputable conduct (itself a basis for suspension or disbarment under Circular 230 rules) the rendering of intentionally or recklessly misleading tax shelter opinions, as well as patterns of providing incompetent opinions in other federal tax matters. The proposed amendments also revised section 10.52, dispensing with the willfulness requirement for prosecuting violators of the new rules. Thus, misconduct rising only to the level of negligence or incompetence might be grounds for suspension or disbarment from practice before the IRS.

Section 10.33 contained the heart of the amendments. The new section required practitioners providing tax shelter opinions to conform their behavior to standards of practice that exceeded existing ethical standards promulgated by professional organizations. In particular, the amendments required practitioners to exercise elevated due diligence standards to ensure (1) that opinions (or offering materials) fully and fairly disclose facts affecting each important federal tax issue; (2) that opinions fully and fairly describe and state a conclusion as to the likely outcome of each important federal tax issue; and (3) that opinions were accurately and clearly described in discussions of tax considerations in the offering materials.[3] The proposed amendments also prohibited opinions that failed to reach a ''more likely than not'' conclusion that ''the bulk'' of the tax benefits flowing from the shelter were allowable under the tax law.[4] Thus, practitioners were prevented from issuing negative opinions as well as the industry standard, reasonable basis opinions. Limited scope opinions were restricted, too.

The amendments were designed to shut down the mass marketing of tax shelters to nonclient investors. Tax shelter promoters were using legal opinions to sell and mass-market tax shelters. The proposed amendments to Circular 230 exempted written advice provided to the practitioner's own client (or clients) on the theory that an individual client could meet face-to-face with his attorney to discuss participation in a prospective shelter investment. A nonclient investor did not have the same opportunity.

The frontal attack on the tax shelter industry prompted Treasury to define broadly ''tax shelter'' and ''tax shelter opinion.'' A tax shelter opinion under the proposed regulations was written advice relating to federal tax law that the opinion writer ''knows or reasonably should know'' would be used in offering materials distributed to nonclients in connection with the promotion of a tax shelter.[5] A tax shelter was defined even more broadly: a sale, offering, syndication, promotion, investment, or other transaction ''in which the claimed tax

[1]Proposed Amendments, Tax Shelters; Practice Before the Internal Revenue Service, 45 *Fed. Reg.* 58594 (Sept. 4, 1980), at Supplementary Information.

[2]*See, e.g.,* Jerome Kurtz, ''Kurtz on 'Abusive Tax Shelters,''' *Tax Notes*, Feb. 18, 1980, p. 213; Robert H. Mundheim, ''Mundheim on 'Abusive Tax Shelters,''' *Tax Notes*, Feb. 18, 1980, p. 213. For a fuller discussion, see Dennis J. Ventry Jr., ''Tax Shelter Opinions Threatened the Tax System in the 1970s,'' *Tax Notes*, May 22, 2006, p. 947.

[3]Section 10.33(a)(1).

[4]Section 10.33(a)(2).

[5]Section 10.33(c)(3).

benefits are likely to be perceived by the taxpayer as the principal reason for his or her participation.''[6] More than expansive, the tax shelter definition required the practitioner to intuit taxpayer intent regarding an investor's reasons for participating in the proposed tax shelter transaction, an onerous requirement given that the transactions for which opinions were being written were marketed to dozens, even hundreds, of nonclients.[7]

An expansive rule with tough requirements allowed Treasury to be nimble in its attack on tax shelter opinions and their authors. In particular, it allowed Treasury to regulate the four ''troublesome'' opinions.[8] The new due diligence standard required practitioners to fully and fairly disclose facts associated with aggressive tax positions — imposing a duty to examine offering materials — and to be satisfied that the facts on which the opinion was based were accurate and complete. It required the practitioner ''to be alert to inconsistencies or implausibilities in the facts as presented to him or her and to resolve any doubts before rendering an opinion.'' Those requirements addressed the ''intentionally false or incompetent'' opinion or one that knowingly or recklessly misstated the law or the facts, as well as the opinion that relied on questionable factual representations of the promoter. Regarding legal matters, the due diligence standard required practitioners to state a conclusion as to the likely legal outcomes of each tax position, and it prevented practitioners from relying on the reasonable basis standard without fully and fairly describing those outcomes. Those requirements addressed opinions that never offered legal conclusions on the tax aspects raised by particular tax shelter offerings, as well as reasonable basis opinions that indicated indirectly or through obfuscatory language that the taxpayer might lose if the position or positions were challenged.

The new more likely than not standard provided Treasury with its most potent weapon against abusive tax shelters.[9] The requirement that a practitioner provide a tax shelter opinion only if it concluded that it was more likely than not that the bulk of the tax benefits would be allowed constituted a significant step in the regulation of tax practitioners. Prevailing ethical standards allowed a practitioner to ''properly advise a client to take a deduction with respect to a consummated transaction so long as the practitioner in good faith believes there is a reasonable basis for such a position, even though he or she also believes that the deduction would ultimately be disallowed.'' The new more likely than not standard was promulgated in the belief that tax practitioners owed ''greater responsibility when their opinions are used to help merchandise an investment proposal to persons who are not their clients.'' In that way, the new standard reflected Treasury's primary concern with the possible defrauding of the government rather than with investor protection. Tax shelter investors often sought to evade their fair share of the taxes, ''and disclaimers as to the weakness of the scheme may not sufficiently deter the successful promotion of these ventures.'' Treasury's chosen deterrent was to forbid participation by practitioners in schemes they knew would ultimately fail, because that association suggested ''their endorsement of the promotion.'' The more likely than not requirement meant that practitioners were prohibited from issuing negative opinions to nonclients.[10] A practitioner was still entitled to disagree with the IRS, but only if he ''honestly believes the courts would ultimately sustain the position.''

The more likely than not standard provided further leeway for Treasury in that ''bulk of the tax benefits'' was defined ambiguously.[11] According to the supplemental materials, the ''bulk of the tax benefits'' language corresponded to ''substantially more than 51%,'' and would somehow ''become apparent from the substance of a particular transaction and its presentation in the offering materials.'' The guidance was less than clear. Moreover, the single explanatory example — indicating that 80 percent would qualify — gave practitioners little reason to think that ''bulk'' would ever be construed as residing closer to 50 percent rather than 100 percent.

II. The Tax Bar Reacts

The reaction of the organized bar to the proposed amendments was predictably negative. The American Bar Association Section of Taxation acknowledged that a tax shelter problem existed and that tax practitioners should be required to comply with ''minimum rules of conduct'' in providing tax shelter opinions.[12] The ABA Tax Section also accepted Treasury's right to challenge tax practitioners' privilege to practice before the IRS when they fail to comply with those rules.[13] But beyond those concessions, the ABA Tax Section found little to like about the Treasury proposal. It doubted the wisdom of using disciplinary rules to attack tax shelters; it argued

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[6]Section 10.33(c)(2).

[7]Treasury considered an alternative definition that would have defined a tax shelter in terms of transactions ''in which the claimed tax benefits are set forth in the offering materials or otherwise described as a principal reason for the taxpayer's participation,'' but limiting coverage of the rule to an enumerated set of tax shelters considered abusive. Those shelters, Treasury said, might be defined as those in which ''it is contemplated that the aggregate deductions, credits, and other allowances that a taxpayer may claim within 24 months of his or her initial cash outlay will equal or exceed the amount of such cash outlay (disregarding any cash to be obtained by borrowings, except full-recourse borrowings from financial institutions unrelated to the taxpayer, promoter, or other participants).''

[8]Citations in this paragraph are from Proposed Amendments, *supra* note 1, at Supplementary Information.

[9]*Id.*

[10]Treasury did not take a position regarding a practitioner's responsibility in tax planning for his own client when the practitioner structured or advised regarding a transaction that he believed would be disallowed if challenged but as to which he possessed a reasonable basis for endorsing.

[11]Citations in this paragraph are from Proposed Amendments, *supra* note 1, at Supplementary Information.

[12]American Bar Association Section of Taxation, ''Statement on Proposed Rule Amendment Circular 230 with Respect to Tax Shelter Opinions,'' 34 *Tax Law.* 745, 746 (Spring 1981) (the report served as the basis for testimony by the ABA Tax Section at Treasury hearings in November 1980).

[13]*Id.*

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that ethical guidelines should come from professional organizations rather than the government; and it considered the definition of tax shelter to be too broad. Also, the ABA Tax Section believed that requiring lawyers to opine on every ''important Federal tax aspect'' would result in highly qualified, prolix opinions; that Treasury lacked authority to impose the more likely than not standard on legal opinions; that the standard conflicted with disclosure requirements under federal securities law; and that willfulness rather than mere negligence or incompetence should be a prerequisite to disciplinary action against noncompliant practitioners.

In November 1980 the ABA Tax Section laid out its critique of the new rules during hearings on the proposed amendments. Preliminarily, it issued two ''cautionary admonitions'' regarding the efficacy of using disciplinary rules to attack tax shelters.[14] First, it would not solve the problem. Shelters were being promoted without tax opinions, and ''bad'' tax opinions were being provided by persons who did not practice before the IRS and who were undeterred by the threat of disbarment from that practice. Second, disciplinary rules diverted attention from other approaches that might be ''equally or even more effective in curbing undesirable tax shelters.''[15] Those alternative approaches included a more aggressive audit program for partnerships, attacking straddles involving commodity and Treasury bills, carefully defining value for property contributed to charities, and increasing investor penalties.

More generally, according to the ABA Tax Section, Treasury should not be in the business of regulating practitioners. Primary responsibility for the promulgation and enforcement of ethical and disciplinary rules relating to tax practice ''should rest with those professional associations whose members engage in that practice.''[16] And in fact, the ABA Tax Section's Committee on Standards of Tax Practice had drafted a suggested ethics opinion on tax shelter opinions that it had submitted to the ABA's Standing Committee on Ethics and Professional Responsibility for review. One ''obvious reason'' disciplinary action should be handled by professional organizations rather than the administrative agencies before which they practice was that those agencies ''suffer from inherent conflicts of interest.'' That was particularly true of Treasury, in front of which tax lawyers represented clients and which often acted as both ''prosecutor and judge'' in disciplinary actions.

The ABA Tax Section also provided specific critiques of the proposed regulations. Treasury's definition of tax shelter was too broad, as well as too subjective and too vague.[17] How was the lawyer to determine whether the claimed tax benefits were ''perceived'' by the taxpayer as ''the principal reason'' for his participation in the proposed transaction? How could the lawyer know what the offerees were thinking, particularly if there were hundreds of them, usually anonymous investors with whom the lawyer had little or no contact? Was the lawyer to make the same query regarding the perceived tax benefits of noncontroversial tax planning, such as investments in tax-free municipal bonds or stock offerings that might lead to capital gains? What if an entity chose to organize as a limited partnership rather than a corporation because it anticipated losses in the first few years? Was that kind of tax planning to be construed as participating in tax shelter activity, requiring a legal opinion that adhered to the standards required under Circular 230?

The ABA Tax Section offered several clarifying suggestions to address the various uncertainties surrounding Treasury's tax shelter definition. First, Treasury should specifically exclude from the definition transactions that were not generally regarded as tax shelters (such as municipal bonds, life insurance policies, annuities, IRAs, and corporate reorganizations). Second, Treasury should remove the subjective requirement of gleaning investor intent. The ABA Tax Section offered a more restrictive tax shelter definition that reflected its recommendations.[18]

Requiring the practitioner to comment on every ''important Federal tax aspect'' was also overinclusive.[19] That requirement would produce ''unnecessarily long and complex'' opinions that wasted time and resources describing what amounted to innocuous tax aspects of planning transactions. ''Not only would this be unduly expensive for the promoter, and ultimately for the investor,'' the ABA Tax Section said, ''but the rule might prove counterproductive with regard to the Treasury's own goals since the utility of the opinions would be impaired.''

The due diligence requirements imposed an equally heavy burden on practitioners and clients.[20] Any such obligation, the ABA Tax Section maintained, ''should embody the principles developed under the securities laws and should be consistent with customary and sound tax law practices in other areas.'' The proposed regulations, however, required a considerably higher standard both regarding factual and legal due diligence. The amendments strongly suggested that practitioners should audit clients in unnecessary and invasive ways, such as ''independently verify[ing] a corporate general partner's 'net worth''' or ''evaluat[ing] an appraisal by a purported expert with impeccable credentials'' on whose estimate some aspects of the transaction depended. The ABA Tax Section believed that a tax practitioner, like securities lawyers and CPAs, should be allowed to rely on representations of facts by clients or on the opinions of credentialed experts, ''provided that nothing he has seen reasonably leads him to believe to the contrary.''

[14]*Id.* at 747.
[15]*Id.*
[16]*Id.*
[17]*Id.* at 749.

[18]*Id.* at 750-751. The ABA Tax Section defined tax shelter as an investment in which ''(1) the purported tax benefits are a principal feature and (2) a significant portion of such tax benefits would be likely to be challenged by the Internal Revenue Service if the investor were audited with regard to such benefits.'' Emphasis in the original.
[19]*Id.* at 751.
[20]*Id.* at 751-752.

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While the due diligence requirements were burdensome, the new more likely than not standard was illegitimate. Treasury's authority to issue disciplinary rules for tax practitioners was restricted to regulating the good character of individuals practicing before the IRS. Under the more likely than not standard, practitioners were prohibited from issuing negative opinions. But such a prohibition, the ABA Tax Section argued, could hardly be said to reflect on the character of the practitioner. Also, the more likely than not standard conflicted with Securities and Exchange Commission releases *requiring* tax opinions in specific types of public offerings even if the opinion reached an ultimately negative conclusion. The proposed regulations "would have the effect of *prohibiting* an offering of the type covered by the SEC Releases where the attorney could not in good faith render an opinion that the sought-after tax benefits were 'more likely than not' to be allowable."[21]

The ABA Tax Section offered alternative practice standards.[22] As to each important federal tax issue, the practitioner should state his carefully reasoned honest opinion, which could include: more likely than not; approximately equal likelihood; less than probable with reasonable basis; unlikely and without reasonable basis; and impossible to predict. As to the bulk of the tax benefits, the ABA Tax Section added to the dizzying array of standards by suggesting that the opinion writer could conclude that it is more likely than not that the bulk of the tax benefits are allowable; it is likely that the bulk of the tax benefits are not allowable; or he is unable to opine on the outcome for whatever reason.

Before concluding, the ABA Tax Section urged Treasury to include willful behavior as a prerequisite to disciplinary action under new section 10.33.[23] Moreover, it recommended that the proposed regulations include a peer review system to ameliorate conflict of interest concerns regarding Treasury's dual role as both prosecutor and judge in disciplinary proceedings, particularly given that the new practice standards "transcend[ed] traditional concepts of ethical behavior."[24] The ABA Tax Section proposed a panel of independent attorneys to review allegations of misconduct under the new tax shelter opinion rules and to decide whether to recommend the commencement of disciplinary action against individual attorneys. Parallel procedures would be required for accountants and enrolled agents that reflected their unique ethical and professional standards.

III. The Sky Is Falling: Tax Lawyers React

The ABA Tax Section's reaction to the proposed regulations, while critical, was subdued compared with the visceral reaction of other organizations and individual practitioners who objected to what they perceived (quite correctly) as a strategy of attacking tax shelters by attacking tax lawyers.

[21]*Id.* at 746. The ABA Tax Section referred to SEC Releases Nos. 33-6230 and 34-17095. Emphasis in the original.

[22]*Id.* at 753.

[23]*Id.* at 754.

[24]*Id.* at 748.

Most tax lawyers and their organizations endorsed Treasury's general effort to reduce abusive tax shelter activity. The New York State Bar Association (NYSBA) Tax Section, for instance, "share[d] the Treasury's concern that the greatly expanded numbers in recent years of tax shelter offerings available to the general public have too often included tax opinions that do not represent the highest ethical standards."[25] NYSBA also acknowledged that the "presence of a lawyer's opinion does help to sell a tax shelter offering," whereby an "indeterminate number of investors in tax shelters are ignorant of the subtleties involved and unable to evaluate the complexities of the legal discussion."[26] Unsophisticated investors viewed the mere presence of a legal opinion as an indication that the desired tax benefits will be achieved. Meanwhile, sophisticated investors understood perfectly well that the shelter was questionable, but they "assume that the lawyer's opinion means that the transaction — at least as to the investor — provides a possible reporting position that may prevail if audited."[27] NYSBA even admitted that the rendering of an opinion regarding modern tax shelters made the tax lawyer's role look more like an adviser than an advocate.[28] Those opinions were provided to shelter promoters who used them as part of their sales materials to persuade nonclient, anonymous investors in deciding whether to purchase the tax shelter.[29]

Despite an appreciation of the unique circumstances and ethical obligations confronted by tax practitioners in the arena of tax shelter opinions, tax lawyers did not perceive the need for special rules governing tax practice. Even NYSBA believed that the Code of Professional Responsibility applicable to attorneys provided sufficient "guidance for the formulation of standards of practice pertinent to tax shelter opinions, which, though subject to special considerations, are not unique in the practice of law."[30] Like other professional groups and individual practitioners, the NYSBA "urge[d] the Treasury Department to withdraw the proposed amendments to Circular 230 and to allow the bar, at least for a reasonable trial

[25]New York State Bar Association Tax Section, "Circular 230 and the Standards Applicable to Tax Shelter Opinions," *Tax Notes*, Feb. 9, 1981, p. 251 at 252.

[26]*Id.* at 253.

[27]*Id.*

[28]*Id.* at 253-254.

[29]For additional support from tax lawyers for Treasury's general effort to curb tax shelter activity, see James B. Lewis, "The Treasury's Latest Attack on Tax Shelters," *Tax Notes*, Oct. 13, 1980, p. 723; Laurence Goldfein and Stanley Weiss, "An Analysis of the Proposed Changes Under Circular 230 Affecting Tax Shelter Opinions," 53 *The J. of Tax*. 340, 345 (December 1980); Paul J. Sax, "Lawyer Responsibility in Tax Shelter Opinions," 34 *Tax Law.* 5 (1980-1981); James B. Lewis, "Lawyer's Ethical Responsibilities in Rendering Opinions on Tax Shelter Promotions," *Tax Notes*, Apr. 13, 1981, p. 795; John André LeDuc, "The Legislative Response of the 97th Congress to Tax Shelters, the Audit Lottery, and Other Forms of Intentional or Reckless Noncompliance," *Tax Notes*, Jan. 31, 1983, p. 363.

[30]NYSBA Tax Section, *supra* note 25, at 261.

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period, to seek to remedy any improprieties in the practice with respect to tax shelter opinions.''[31]

Disciplinary rules that originated outside the auspices and scope of traditional ethical and professional guidelines were sure to fail, and might even exacerbate the tax shelter problem. An absolute prohibition on opinions that did not reach a more likely than not conclusion suffered from the effects of Gresham's law.[32] The lawyer who concluded that the intended position, although reasonable, would probably lose was prohibited from rendering the opinion. Meanwhile, the lawyer who concluded that the position would likely succeed could freely give the opinion. ''Opinion writing in such cases will therefore simply gravitate to the lawyers with the most sanguine outlook, but will not be prevented.''[33] Investors would ''lose the opportunity to hear the 'you'll probably lose' warning. It is difficult to see,'' NYSBA observed, ''how this will do much to help protect either prospective investors or the revenue.''[34]

The fear among tax practitioners that clients shopped around for a favorable opinion may have had less to do with protecting clients and the revenue, and more to do with protecting lawyers. Tax lawyers were worried that increasing numbers of their colleagues were writing shoddy opinions and that ''Everybody's doing it''[35] was used to justify professional misconduct. Many practitioners explicitly articulated such a connection. ''The justification of some,'' James Lewis reported, ''is that 'Everybody does it.'''[36] Moreover, according to William Raby, the proposed Circular 230 regulations were doomed to fail. Promoters would simply seek out accommodating lawyers to write more likely than not opinion letters.[37] Jacques Schlenger and John Watkins predicted a similar outcome. While the new Circular 230 rules ''may influence the rendering of tax opinions by responsible members of the bar, it will likely have little effect on that minority of practitioners who [previously] abused . . . standards and statutes, and who will likely continue doing so.''[38] Although some commentators argued that those fears did not justify abandoning the goals of the proposed amendments,[39] most tax lawyers thought that the proposed regulations would create more problems than they purported to solve. Echoing the criticisms of the ABA and NYSBA tax sections, practitioners went on the offensive.

The tax shelter definition was too broad. Treasury was going after abusive tax shelters with a shotgun rather than a bullet, pulling in noncontroversial transactions.[40] The definition rested erroneously on ''the facile notion'' that by compartmentalizing investment motives into a tax-oriented component on one hand and a non-tax-oriented component on the other, one could ''isolate those investments that should be disfavored.''[41] If such an analysis was dispositive of tax shelter activity that should be regulated, the capital gains deduction, accelerated depreciation, the investment tax credit, depletion allowances, and other provisions specifically sanctioned by Congress would qualify. The definition also ''imposed an unworkable professional burden'' on practitioners in that it required them to divine motive of nonclient tax shelter investors.[42]

Invasive rather than divine behavior was required of tax practitioners under the new due diligence standard. The proposed regulations turned attorneys into investigators of the underlying facts of proposed transactions, a function that historically had been the responsibility of the promoter and the SEC. Therefore, like the NYSBA Tax Section, practitioners recommended that Treasury adopt standards of due diligence equivalent to those required under the securities laws.[43] The proposed amendments should be modified, moreover, ''to dispel any concern that practitioners generally will be required to inspect the building site, review real estate records or otherwise take steps to make an independent verification of the facts.''[44] An unmodified due diligence standard would result in practitioners ''explaining and analyzing every tax feature in excruciating, mindnumbing detail,'' and produce unnecessary verbiage that would further confuse and possibly mislead investors.[45] An unmodified requirement to fully and fairly describe all important federal tax issues would have a similar bloating effect on opinions without improving clarity.[46]

Predictably, no specific new requirement caused more consternation among practitioners than the more likely than not standard. The requirement was particularly onerous, forcing a practitioner to come to a more likely than not conclusion or give no opinion at all.[47] Moreover, the standard was subjective, no more precise than the

[31]*Id.*
[32]*Id.* at 258.
[33]*Id.*
[34]*Id.*
[35]Report of the Committee on Standards of Tax Practice, ABA Tax Section, ''Guidelines to Tax Practice,'' 31 *Tax Law.* 551 (1978).
[36]Lewis, *supra* note 29, at 724.
[37]Raby quoted in Tim N. Vettel, ''Circular 230 Exposure Draft Is Expected Soon,'' *Tax Notes*, Nov. 15, 1982, p. 561.
[38]Jacques T. Schlenger and John B. Watkins V, ''Exploring the Myths of Circular 230,'' 62 *Taxes* 283, 291 (May 1984).
[39]*See, e.g.*, Goldfein and Weiss, *supra* note 29, at 341 (''It has been argued that promoters will no longer ask for tax shelter opinions from reputable practitioners if the proposed amendments are adopted, but that hardly would justify their abandonment'').
[40]Bruce Lane quoted in ''Practitioners Attack Limits on Tax Shelter Opinions,'' *Tax Notes*, Dec. 8, 1980, p. 1143.
[41]Thomas Volet, ''Circular 230 and the Definition of a Tax Shelter,'' *Tax Notes*, Apr. 27, 1981, p. 949.
[42]*Id.*
[43]*See* note 40. *See also* NYSBA Tax Section, *supra* note 25, at 254. Some practitioners objected to using the SEC due diligence standard on the theory that ''the roles of the tax practitioner and the securities lawyer are so inherently different'' that it would not ''provide a useful model.'' *See also* Goldfein and Weiss, *supra* note 29, at 342.
[44]*Id.*
[45]Gerald J. Robinson, ''Attacking Tax Shelters — IRS in Blunderland?'' *Tax Notes*, Mar. 23, 1981, p. 646.
[46]Goldfein and Weiss, *supra* note 29, at 342.
[47]*Supra* note 40, at 1143.

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reasonable basis standard it was meant to replace.[48] Further, in many instances it was difficult to ascertain whether the bulk of tax benefits from the transaction would be realized. On top of the usual hazards of predicting outcomes for individual tax benefits that in the aggregate made up the bulk of tax benefits, and were often interdependent regarding individual "success" or "failure," the law was so unsettled on particular issues that the investor's chance of success may have been sizable but not substantially more than 51 percent.[49]

The more likely than not standard also prohibited three kinds of opinions that tax lawyers had grown accustomed to giving: the no conclusions opinion, the limited scope opinion, and the negative opinion. Tax lawyers argued that the no conclusions opinion served a useful purpose, particularly when the law was unsettled and it was difficult to conclude as to likely outcomes.[50] Moreover, there was no self-evident reason for prohibiting limited scope opinions, which tax lawyers regularly wrote, covering only those elements of the tax shelter for which an opinion was sought.[51] Tax lawyers also noted that ABA Formal Opinion 314 permitted attorneys to give negative opinions as long as there was full disclosure of the negative conclusion.[52] In meetings with tax practitioners, Treasury countered that a limited or negative statement by a reputable law firm could be interpreted by investors, sophisticated or otherwise, as a statement of acceptance of the entire tax shelter.[53]

Some practitioners expressed less concern for investor clients, belying pious assertions of zealous advocacy and exposing professional self-interest. Many tax lawyers were unsympathetic to investor ignorance, and particularly to Treasury's argument that opinion writers should be regulated to protect investors. "The fact that an investor may be misled by an opinion of such limited scope," NYSBA argued, "either because the investor does not read it carefully or because he lacks the ability to understand it fully, does not provide a proper basis for concluding that such an opinion, if accurate and competent, cannot be given."[54] In the end, an opinion "must be judged by the degree of complexity of the subject matter it covers and by its own terms, and not by the potential human shortcomings of those who might read it."[55] Moreover, according to Jacques Schlenger, there was no statutory authority granting the IRS the right to determine whether an investor must be a prudent investor.[56] So much for protecting clients from running afoul of the law.

Self-interest also informed tax lawyers' reaction to the punitive disciplinary provisions of the new Circular 230 rules. Tax lawyers recoiled in collective professional fear over the lack of a willfulness requirement as a prerequisite to disciplinary action under new section 10.33. Lawyers argued that they should be allowed to establish a negligence or honest mistake defense to potential violations.[57] By statute, disreputable or incompetent behavior was punishable under Circular 230, but mere negligence surely did not reach the level of disreputable or incompetent behavior worthy of punishment resulting in suspension or disbarment.

A. Self-Regulation and Self-Interest

Practitioners saved their harshest criticism of the 1980 proposed amendments to Circular 230 for Treasury's endeavoring to regulate their behavior in the first place. The reaction was a strange combination of thoughtful commentaries on the relationship between the Treasury Department and tax practitioners, and shrill, knee-jerk defenses of a profession's right to regulate itself. The discussion, both cerebral and guttural, exposed deep divisions over where tax lawyers resided on the spectrum between zealous advocate and dispassionate adviser.

The commentary could be quite philosophical. Ethical and disciplinary rules had to be sensible if they were to succeed. "When they demand too much," Paul Sax, future chair of the ABA Tax Section, wrote, invoking Boris Bittker, "legal and ethical systems fall of their own weight in practice, even though they may linger on to be

[48] *See id.*; Goldfein and Weiss, *supra* note 29, at 342; NYSBA Tax Section, *supra* note 25, at 260-261.

[49] Goldfein and Weiss, *supra* note 29, at 342.

[50] *Supra* note 40, at 1143.

[51] NYSBA Tax Section, *supra* note 25, at 258-259. To the extent Treasury was concerned that investors could mistakenly believe that a limited scope opinion represented a full endorsement of the tax shelter transaction, some practitioners suggested the use of ubiquitous and prominent legends alerting investors to the limited nature of the opinion. Goldfein and Weiss, *supra* note 29, at 342. That suggestion, seemingly intended as an innocuous quick fix in 1980, has become an infamous requirement of more recent changes to Circular 230. *See, e.g.*, Michael Schler, "Effect of Anti-Tax-Shelter Rules on Nonshelter Tax Practice," *Tax Notes*, Nov. 14, 2005, p. 915; Sheryl Stratton, "Sample Circular 230 Legend List," *Tax Notes*, July 4, 2005, p. 52; Sheryl Stratton, "Circular 230 E-Mails, T-Shirts, Attain 'Legendary' Status," *Tax Notes*, July 4, 2005, p. 48; Sheryl Stratton, "Amid Circular 230 Concerns, Official Says 'We Hear You,'" *Tax Notes*, June 20, 2005, p. 1480; "Association of the Bar of the City of New York Comments on Circular 230 Regulations," (May 10, 2005) *Doc 2005-11435*, *2005 TNT 101-26*.

[52] R. Eliot Rosen, "Tax Section Meeting Discusses Shelter Opinion Rules, TEFRA," *Tax Notes*, Aug. 16, 1982, p. 701. The NYSBA Tax Section undertook a vigorous defense of opinions that did not reach a more likely than not conclusion regarding the tax benefits of a shelter transaction, arguing that prohibiting those opinions "would have the effect of eliminating quite proper challenges to interpretations that may not necessarily prevail." Negative opinions created a level playing field. "The Treasury frequently takes such positions [on unsettled and unfavorable law], and taxpayers should have the same opportunity." NYSBA even resorted to somewhat fanatical suggestions that "freedom" and "liberty" were being undermined by Treasury's one-sided attempt to regulate tax practice, and that the adversarial system was under attack. NYSBA Tax Section, *supra* note 25, at 259-260.

[53] *Supra* note 40, at 1143.

[54] NYSBA Tax Section, *supra* note 25, at 258.

[55] *Id.*

[56] Jacques T. Schlenger, "Comments on the Proposed Regulations on Tax Shelter Opinions," 59 *Taxes* 173, 179 (March 1981).

[57] Goldfein and Weiss, *supra* note 29, at 344.

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invoked on ceremonial occasions.''[58] Such was the fate of the proposed regulations absent significant modification. Their ''principal failure'' was that they were ''too ambitious,'' Sax suggested, ''imposing standards of conduct more exacting than any present legal or even ethical requirement.''[59] Generally speaking, ''administrative agency regulation of those that practice before it should be approached with caution,'' because those agencies possessed ''no special expertise in adjudicating disciplinary matters, and due process standards tend to be less strictly enforced.''[60] Thus, disciplinary adjudication within the administrative agency could create ''a chilling effect on advocacy, when a vigorous and independent advocacy is essential to an adversary system of justice.''[61] But, Sax concluded, Treasury could and should undertake to discipline those who practice before it. ''Discipline and regulation of opinion writers does not necessarily endanger the adversary system, because the tax opinion writer functions primarily as an adviser, not an advocate.''[62]

It remained to be seen whether regulating the opinion writing of tax lawyers would have any material effect on tax shelter activity. In fact, Sax himself identified the essence of the tax shelter problem as taxpayer incentives (or insufficient *dis*incentives) to invest in tax shelter transactions rather than the role of the tax lawyer.[63] The tax bar also doubted the efficacy of dealing with the tax shelter problem by regulating attorneys.[64] And NYSBA queried whether it was ''appropriate at all for the Treasury to try to adopt a regulation in this area and thus to embark upon such a major change in the relationship between the government and practitioners.''[65] The better solution for establishing and raising uniform ethical behavior of tax practitioners was to leave ethical and disciplinary rules to professional organizations.[66] Most tax lawyers also preferred deferring to state bar associations for enforcement of ethical standards, despite those organizations' poor track record in that area.[67] Given the ''hornets' nest'' stirred up by the proposed regulations, practitioners argued that previously lax state bar associations would be motivated to take stringent measures against abusive tax shelters if given the responsibility.[68]

Even if the organized bar failed to act altogether, it was unclear whether Treasury had the authority to regulate the conduct of practitioners. Treasury maintained that it possessed independent statutory authority to discipline incompetent and unethical conduct by practitioners under 31 U.S.C. 1026 and 5 U.S.C. 301.[69] Under 31 U.S.C. 1026 (and subject to 5 U.S.C. 301, authorizing an attorney in good standing to represent a person before a government agency), Treasury could ''prescribe rules and regulations governing the recognition of agents, attorneys, or other persons representing claimants before this department.'' Also, Treasury was authorized ''after due notice and opportunity for hearing'' to ''suspend and disbar from further practice'' before Treasury any such person, agent, or attorney ''shown to be incompetent, disreputable, or who refuses to comply with the said rules and regulations.'' The plain language of the statute was clear: Treasury could regulate the conduct of tax practitioners and could suspend or disbar those practitioners whose behavior rose to the level of incompetence or disrepute, or who failed to comply with the rules and regulations.

While many practitioners acknowledged Treasury's statutory authority to regulate practitioner behavior,[70] others challenged it. The primary contention of naysayers involved the characterization of a practitioner giving a reasonable basis opinion, limited scope opinion, or negative opinion as an example of incompetent or disreputable conduct authorizing suspension or disbarment.[71]

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[58]Sax, *supra* note 29, at 41, quoting Boris I. Bittker, *Professional Responsibility and Federal Tax Practice* (New York: New York University Press, 1965), at 24. Sax was not only thoughtful in his commentary, but dedicated to the uplift of the tax bar. He served in various capacities for the ABA Tax Section, including chair of the Subcommittee on Lawyers' Opinions on Tax Subjects of the ABA Tax Section Standards of Tax Practice Committee, cochair of the Tax Opinions Subcommittee of the ABA Tax Section Committee on Tax Shelter Study, and ultimately, chair of the Tax Section.

[59]*Id.* at 41-42. *See also* Lewis, *supra* note 29, at 798 (noting that the proposed amendments ''threaten to outpace in development the ethical guidelines. We have been accustomed to say that not everything that is legal is ethical. We may have to learn to say that not everything that is ethical is legal.'').

[60]*Id.* at 44.

[61]*Id.*

[62]*Id.*

[63]*Id.* at 46.

[64]*Supra* note 16.

[65]NYSBA Tax Section, *supra* note 25, at 261.

[66]ABA Tax Section, *supra* note 12, at 747-748.

[67]*See supra* note 40; William L. Taylor Jr., ''Attorney Defends Profession Against Proposed Amendments to Rules on Tax Shelter Opinions,'' *Tax Notes*, Oct. 13, 1980, p. 743. Not all practitioners would have deferred to the organized bar for ethical and disciplinary standards. *See, e.g.*, Lewis, *supra* note 29, at 725 (the ''balkanization of discipline among several separate professional groups'' produces ''great unevenness and ineffective enforcement''); *supra* note 40 (quoting former IRS Commissioner Don Alexander, objecting on uniformity grounds to a Treasury proposal for phasing out the proposed regulations as each state's bar association instituted a formal plan for disciplining its members for participating in abusive tax shelter plans); Sax, *supra* note 29, at 44.

[68]*Supra* note 40, quoting Charles Egerton of the Florida Bar Association Tax Section.

[69]That authority was originally contained in Stat. 258, ch. 334, section 3 (July 7, 1884), codified as 31 U.S.C. section 330.

[70]For practitioners acknowledging Treasury's statutory authority, see Lewis, *supra* note 29, at 725 (''Clearly, the Treasury has the statutory authority to regulate this area if it wishes to do so''); *supra* note 40, at 1143 (quoting former Commissioner Don Alexander stating that Treasury has full authority to issue the regulations); Sax, *supra* note 29, at 44 (stating ''the Treasury should discipline those that practice before it'').

[71]*See* Schlenger, *supra* note 56, at 178 (''The portion of the proposed regulations forbidding issuance of an opinion on tax shelters unless the 'more likely than not' standard is met would certainly not be reasonably related to the competency or repute of the attorney . . . . Since the proposed regulation on unfavorable opinion letters has no reasonable relation to the character, repute or competency of an attorney, it is apparent that Treasury

(Footnote continued on next page.)

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Also, challengers to Treasury's authority to regulate the conduct of lawyers practicing before it argued that the proposed rule ''impinges on the taxpayer's right to counsel.''[72] The ABA Tax Section alluded to that effect,[73] while NYSBA warned of risks ''in trying to reduce the amount of tax shelter offerings by attacking the lawyers involved'';[74] that strategy ''pose[d] an incipient threat to the right of American citizens to be represented by independent counsel.''[75] In fact, according to NYSBA, the strategy reflected an oppressive government out to squelch the rights of citizens.[76]

As the foregoing suggests, the tax practitioner commentary could also be quite reactionary. Articulated fears of administrative overreach and violations of civil liberties further exposed the self-interest of an overzealous bar and excessively aggressive membership.[77] At the very least, those fears revealed that some elements of the bar steadfastly considered the IRS an adversary; tax lawyers were advocates rather than advisers. Those elements rejected Treasury's view that participating in abusive tax shelter activity by providing opinions to nonclient investors amounted to disreputable or incompetent conduct, punishable with penalties that could result in being stripped of privileges to practice before the IRS.

Some practitioners noted that Treasury was not necessarily helping its nonadversarial cause by acting as both ''prosecutor and the judge'' in the resolution of tax shelter disputes.[78] Commentators noted that the regulations in Circular 230 were enforced by the director of practice, a Treasury official. The preliminary disciplinary proceedings took place in front of an administrative law judge, and the ALJ's decision was appealable to a delegate of the Treasury secretary, Treasury's general counsel, also an appointed official. Thus, ''the final arbiter of a proceeding brought by the Treasury will be the Treasury itself,'' insisted some practitioners.[79] While the final Treasury decision was in fact appealable to a federal district court, it was ''little consolation'' at that point to the practitioner whose ''reputation and integrity (not to mention his ability to earn a living) will be significantly soiled.''[80]

Concerns over an inherent conflict of interest in Treasury's ability to promulgate and enforce ethical and disciplinary rules were overstated. Circular 230 regulations were indeed enforced by the director of practice, a Treasury official appointed by the secretary. But by order of the secretary, the determinations of the director of practice could not be modified by the IRS commissioner. Therefore, by appointment and authority, the director of practice was independent of the IRS, the agency responsible for prosecuting tax disputes. Also, regulations stipulated that licensed practitioners could not be suspended or disbarred from practice before Treasury until they were accorded a full evidentiary hearing before an ALJ in accordance with the provisions of the Administrative Procedure Act.[81] And while appeals from the ALJ's decision were appealable to the Treasury general counsel, an aggrieved taxpayer had the right to take the matter into the federal courts. Thus, the director of practice implemented an enforcement program that was largely independent of the IRS and that provided administrative due process safeguards and judicial review.

In the end, the reaction of the organized bar, the tax bar, and tax lawyers to the 1980 proposed amendments to Circular 230 was that while the problem they were designed to meet was undoubtedly a serious one in the administration of the tax law, the new rules went too far.[82] Moreover, the rules preempted action by the organized bar and tax bar, which had responded dutifully to Treasury's call for help in early 1980 to address the tax

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has no authority to prescribe it.''); *supra* note 40 (reporting that there was general agreement among practitioners that the Treasury ''exceeded its legal authority'' in promulgating the proposed regulations); Schlenger and Watkins, *supra* note 38, at 287-288, 289 (''It is evident that much of what is contained in the Final Amendments does not reasonably relate to the character, integrity or competence of one who renders tax shelter opinions. Nor can the proposed standards reasonably be deemed to be rules 'regulating the practice of representatives of persons before the Department of the Treasury.' . . . Can anyone seriously contend that the requirement that a tax practitioner not issue an opinion on less than all material tax issues or that a practitioner provide an 'overall evaluation' is in any way related to the character, morals or ethics of the individual providing the opinion?'').

[72]Schlenger, *supra* note 56, at 178. *See also* F. Cleveland Hedrick Jr. and Michael D. Savage, ''Proposed Regulations on Tax Shelter Opinions Said to Threaten Adversary System,'' *Tax Notes*, Nov. 24, 1980, p. 1009 (declaring the relationship between the IRS and tax practitioners an adversarial one, and criticizing the proposed amendments for threatening the adversarial process by permitting Treasury, one of the adverse parties, ''to prescribe limitations on the vigor with which the other party may participate in the process'').

[73]ABA Tax Section, *supra* note 12, at 747 (offering changes to the proposed amendments ''to avoid undue interference in the attorney-client relationship, and to prevent the rules from interfering with the vigorous and independent advocacy that is an important element in our self-assessment system'').

[74]NYSBA Tax Section, *supra* note 25, at 259.

[75]*Id.* at 252.

[76]*Id.*

[77]Some of the criticism assumed an antiregulatory, antitax tone. ''The Final Amendments constitute an additional unnecessary and unwanted governmental intervention into private transactions and governmental regulation of the behavior of private citizens,'' wrote Jacques Schlenger and John Watkins. *Supra* note 38, at 290. Emphasis in the original. Tax lawyer William Taylor, for his part, wrote to Treasury, arguing that if it was ''concerned about the attitude of taxpayers in complying with the self-assessing system, I call your attention to the fact that the tax burden levied against the taxpayer is too great. If this is corrected, then the attitude of the taxpayer will change dramatically.'' Taylor, *supra* note 67, at 743.

[78]*Supra* note 40, at 1143 (citing tax lawyer Michael D. Savage).

[79]Goldfein and Weiss, *supra* note 29, at 345. *See also supra* note 40, at 1143 (citing similar criticism by David Sachs and Gordon Henderson of the NYSBA Tax Section).

[80]Schlenger and Watkins, *supra* note 38, at 289.

[81]*See* 5 U.S.C. sections 551-559.

[82]Special Committee on the Lawyer's Role in Tax Practice, the Association of the Bar of the City of New York, ''The Lawyer's Role in Tax Practice,'' 36 *Tax Law.* 865 (Summer 1983).

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shelter problem. Indeed, the ABA Tax Section had immediately set about drafting a suggested ethics opinion for the Standing Committee on Ethics and Professional Responsibility,[83] while the NYSBA Tax Section established a committee to recommend standards for the issuance of tax shelter opinions.[84] The ABA Tax Section's efforts resulted in the issuance of ABA Formal Opinion 346, released June 1, 1981, less than one year after Treasury issued the proposed amendments to Circular 230.[85] Also, Congress was about to enter the fray. In both 1981 and 1982, national legislators bulked up statutory penalty provisions, strengthening existing penalties and adding new provisions to the tax code targeting tax shelter promoters and investors. The attempts to regulate the tax shelter marketplace by, respectively, Treasury, the organized bar, and Congress represented three strategies that diverged at some critical junctures and converged at others. The next several years would be spent trying to coordinate the three approaches.

In the next installment of Policy and Practice: ABA Formal Opinion 346 and a New Penalty Regime Under TEFRA.

[83]ABA Tax Section, *supra* note 12, at 748.

[84]NYSBA Tax Section, *supra* note 25, at 251.

[85]The June 1 version of Opinion 346 was subsequently withdrawn and superseded by the Jan. 29, 1982, release of Formal Opinion 346 (Revised), Tax Law Opinions in Tax Shelter Investment Offerings.

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