ETHICS AND STANDARDS OF TAX PRACTICE IN THE NEW AGE OF TRANSPARENCY:

FROM "SELF-ASSESSMENT" TO "SELF-AUDIT"

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1) The government's actions to stop abusive tax transactions

   a) Eliminate the loopholes and increase penalties

   b) Aggressive use of judicial doctrines such as economic substance

   c) Raise the standards of professionalism – see appendix for standards of practice for tax advisors

   d) Aggressive use of penalties

   e) Greater transparency

      i) Tax shelter/reportable transaction disclosures

      ii) FIN 48

      iii) IRS policy regarding tax accrual workpapers

2) Tax shelter/reportable transaction disclosures

   a) Registration and list maintenance requirements for "tax shelters" were established in 1984. Taxpayer disclosure requirements for "reportable transactions" were added in 2000, with final regulations issued in 2003. There were minimal penalties for non-compliance by organizers, and none imposed on the investors.

   b) American Jobs Creation Act of 2004 substantially changed the disclosure regime.

      i) "Material advisor" requirements replaced "organizer/seller" requirements, and apply to "reportable transactions" rather than "tax shelters." "Material advisor" is defined more broadly than "organizer/seller."

      ii) Substantially enhanced penalties for failure to comply with the disclosure and list maintenance requirements.

      iii) Added a new 20% penalty on "reportable transaction underpayments." If the taxpayer does not adequate disclose the transaction, the penalty is increased to 30%.

      iv) Limited the "reasonable cause" exception to accuracy-related penalties.

      v) Further limited the Section 7525 tax practitioner privilege.

      vi) Extended the statute of limitations when the taxpayer does not disclose a listed transaction.

   c) Proposed regulations were issued on November 2, 2006; the most significant changes:

      i) Added a new category of reportable transactions: "transactions of interest."

      ii) Eliminated the tolling provision for the disclosure and list maintenance requirements for ruling requests; if the taxpayer or material advisor does not receive a favorable ruling and the deadline has expired, penalties will apply.

      iii) Clarified what is required to be considered complete disclosure, because some were not providing sufficient information.

      iv) Clarified that protective disclosures must provide the same information as required for a regular disclosure, because some were not providing full disclosure.

      v) Extended deadline for compliance by taxpayers who receive a Schedule K-1, and determine that they indirectly participated in a reportable transaction through the flow-through entity, less than 10 days before the extended due date of the taxpayer's return.

3) FASB Interpretation No. 48 – Accounting for Uncertainty in Income Taxes (FIN 48), available at http://www.fasb.org/pdf/fin%2048.pdf

a) Background

i) FASB Statement No. 109 – Accounting for Income Taxes (FAS 109) sets forth accounting treatment for income taxes but the primary focus was the conceptual treatment of deferred tax liabilities or assets. FAS 109 did not address the issue of uncertainty in the amount of the tax liability.

ii) Those uncertainties were subject to FASB Statement No. 5 – Accounting for Contingencies (FAS 5).

(1) Recognition of loss contingencies – "probable" standard, and requirement that the amount could be reasonably estimated.

(2) Recognition of gain contingencies – "usually are not reflected in the accounts since to do so might recognize revenue prior to its realization."

iii) Different companies used different criteria to recognize, derecognize, and measure benefits related to income taxes. The inconsistent treatment led FASB to issue FIN 48.

b) FIN 48 applies to any company that must report financial statements using GAAP.

c) Effective for years beginning after December 15, 2006.

d) Two step process applied to all income tax positions:

i) Recognition threshold – is it more likely than not, based on the technical merits, that the position will be sustained upon examination?

ii) Measurement analysis – if the position meets the recognition threshold, what is the amount of the tax benefit that can be recognized?

(1) The largest amount of tax benefit with a greater than 50 percent likelihood of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.

(2) For certain highly certain tax positions, management will be highly confident that the full amount of the tax benefit will be realized and no further analysis will be needed.

(3) For others, FIN 48 requires a "cumulative probability" approach.

(4) The analysis would consider facts, circumstances, and information relevant to the determination of **the amounts and probabilities of various settlement outcomes**, including past experience with respect to similar tax positions.

iii) Management's determinations are to be based on the technical merits of the tax position, presuming that the tax position will be examined and that the taxing authority has full knowledge of all relevant information.

e) Required disclosures include:

   i) A tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the accounting period.

   ii) Tax positions for which there is **a reasonable possibility that the total unrecognized tax benefits will significantly increase or decrease within the next 12 months**. The disclosure would address the nature of the uncertainty, the nature of the event that could occur in the next 12 months that would cause the change, and an estimate of the range of the reasonably possible change.

f) FIN 48 does not address what supporting documentation would be necessary other than stating that a legal tax opinion may, but need not, be obtained.

   i) AICPA auditing standards presume that the external auditor has or has access to sufficient experience and knowledge to make an independent assessment, and has the obligation to do so.

   ii) As a practical matter, though, auditors will demand documentation from management to support the reserves.

      (1) A Tax Council Policy Institute survey of the Fortune 500 found that 53 percent of the companies received an auditor request for privileged information in the last two years.

   iii) The FIN 48 supporting documentation would be part of the company's tax accrual workpapers.

4) IRS policy regarding tax accrual workpapers

a) IRS policy:

i) Supreme court recognized the IRS right to obtain tax accrual workpapers in *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

ii) IRS has a traditional policy of restraint, limiting requests to "unusual circumstances." I.R.M. 4.10.20.3.1(2)

(1) A specific issue has been identified by the examiner for which there exists a need for additional facts;

(2) The examiner has sought from the taxpayer and available third parties all the facts known to them relating to the identified issue; and

(3) The examiner has sought a supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue and the examiner has performed a reconciliation of the taxpayer's Schedule M-1 or M-3 as it pertains to the identified issue.

iii) The IRS has expanded the circumstances under which it will request tax accrual workpapers. Ann. 2002-63, 2002-2 C.B. 72; I.R.M. 4.10.20.3.2

(1) Returns filed on or after July 1, 2002, that claim any tax benefit from a listed transaction.

(a) If the listed transaction was not disclosed, the IRS will routinely request all tax accrual workpapers.

(b) If the return claims tax benefits from multiple investments in listed transactions, the IRS as a discretionary matter will request all tax accrual workpapers.

(c) If the listed transaction was disclosed but there are reported financial accounting irregularities, such as those requiring restatement of earnings, the IRS as a discretionary matter will request all tax accrual workpapers.

(d) But if there was only one listed transaction, it was disclosed, and there are no reported financial accounting irregularities, the IRS will request only the tax accrual workpapers pertaining to the listed transaction.

(2) Returns filed after February 28, 2000, but prior to July 1, 2002, that claim any tax benefit from a listed transaction.

(a) The IRS may request tax accrual workpapers pertaining to the listed transaction if the taxpayer had an obligation to disclose the transaction but failed to do so.

(b) The auditor must obtain approval if, due to exceptional circumstances, she decides not to pursue the workpapers. (The Internal Revenue Manual notes, as an example of exceptional circumstances justifying a decision not to request the workpapers, a situation where the taxpayer fully conceded the issue, including penalties, and executed a specific matters closing agreement.)

(c) Ann. 2002-63 does not mention the February 28, 2000, date but the taxpayer requirement to disclose the transaction applies only to returns filed after that date. Treas. Reg. § 1.6011-4(h)

(3) Although the IRS initially applied the policy stated in Ann. 2002-63 only to listed transactions claimed on an original return, it has since been extended to listed transactions claimed on an amended return or claim or refund. The policy is applied as though the benefits of the listed transaction had been claimed on the original return. See "Tax Accrual Workpapers Frequently Asked Questions," posted at http://www.irs.gov/businesses/corporations/article/0,,id=146242,00.html.

(4) Note: The IRS generally requests tax accrual workpapers pertaining to a listed transaction for the years under examination. The request may be extended to other years where directly relevant, such as the year the transaction originated.

(5) In all other situations, the "unusual circumstances" standard still applies.

(6) Office of the Associate Chief Counsel (Procedure & Administration) reviews all requests.

iv) Is the IRS reconsidering its policy of restraint?

(1) Donald Rocen (deputy chief counsel of operations) – November 1, 2006

(a) The IRS is continuing its policy of restraint. Outside the listed transaction environment, "it is basically business as usual. We certainly understand the sensitivity in this area . . . and the need for dialogue."

(2) Deborah Nolan (Commissioner of LMSB) announced in February, 2007, that the IRS is evaluating its policy regarding tax accrual workpapers. According to Robert Adams (senior adviser to Commissioner of LMSB):

(a) New guidance, taking FIN 48 into account, is expected within a three- to six-month timeframe.

(b) Reevaluation is appropriate given that all public policy is moving toward greater transparency. The IRS does not want its tax accrual workpaper policy to lessen the impact of transparency of financial information.

(c) The IRS might reopen an audit, more often than has been the past practice, to ask about a FIN 48 disclosure.

(d) A public "12 month" disclosure might trigger a request for tax accrual workpapers if the change is big enough.

(3) Drita Tonuzi (Office of Chief Counsel) – March 9, 2007

(a) Contrary to published reports, the IRS is not currently revisiting the policy of restraint and has no foreseeable plans to change that policy.

(b) But it is always prudent to conduct a periodic review.

(c) "It is premature to make any decisions regarding the policy until the FIN 48 rules are established and we have a better understanding of how they will impact taxpayers."

b) Summons enforcement action for tax accrual workpapers – *United States v. Textron Inc.*, No. 06-198T (D.R.I., filed Apr. 28, 2006)

i) The taxpayer engaged in multiple SILO transactions in 2001. In 2005, the IRS designated them as listed transactions. The IRS issued a summons for the tax accrual workpapers.

ii) The government's position:

(1) The workpapers are relevant because of the information they may provide. According to a declaration by the revenue agent, these include: a complete explanation of the transactions; whether there was reliance on outside legal advice; **<u>an assessment of the taxpayer's position and potential for sustaining that position</u>**; comments on unwritten agreements, confidentiality agreements, restitution agreements, contingency fees, expectations, and other material facts; **<u>evaluations of the tax strategies by the taxpayer's employees and officers</u>**; the identity of personnel involved with the transactions; the taxpayer's business purpose; **<u>the taxpayer's views concerning potential weaknesses with the proposed tax treatment</u>**; and disclosure that documents for which privilege was claimed were shared with the independent auditors, waiving privilege.

(2) Even if the documents were protected by attorney-client privilege or the work-product doctrine, which the government does not concede, privilege was waived by disclosure to the independent auditor.

iii) Textron's position:

(1) The audit was substantially complete, and the IRS had already issued its formal notice proposing to disallow the tax treatment claimed for the transactions, when the IRS issued a summons for all tax accrual workpapers. The summons was issued for improper purposes:

(a) A "forced revelation of a party's evaluation of his case . . . to take advantage of the other's assessment of his prospects for victory and an acceptable settlement figure." (quoting *Rhone-Poulenc Rorer, Inc. v. Home Indemn. Co.*, 139 F.R.D.

609, 614 (E.D. Pa. 1991)).

(b) Putting pressure on the taxpayer to settle, by offering to withdrew the request if the taxpayer fully conceded the listed transaction.

(2) Tax accrual workpapers are protected under the work product doctrine. *Hickman v. Taylor*, 329 U.s. 495 (1947). Key question: are the workpapers business documents prepared in the ordinary course of business, or legal analysis of litigation hazards and therefore prepared in anticipation of litigation? Nearly absolute perfection is afforded "core work product."

(a) Outside auditors are not "adverse parties" such that disclosure would waive work product protection. Courts are divided on this issue. *Compare Merrill Lynch & Co. v. Allegheny Energy, Inc.*, No. 02 Civ. 7689, 2004 WL 2389822 (S.D.N.Y. Oct. 26, 2004) (disclosure to auditor did not waive work-product privilege); *In re Pfizer Inc. Sec. Litig.*, No. 90 Civ. 1260, 1993 WL 561125 (S.D.N.Y. Dec. 23, 1993) (same) *with Medinol Ltd. v. Boston Scientific Corp*, 214 F.R.D. 113 (S.D.N.Y. 2002) (work-product privilege waived by disclosure to auditor).

(3) Tax accrual workpapers are protected under attorney-client privilege. Disclosure to the outside auditors were protected under the tax practitioner privilege of Section 7525, and therefore did not waive the attorney-client privilege.

5) Effects of the new age of transparency

a) What potentially harmful information will be available to the IRS?

i) Reportable transaction disclosures

(1) Normally taxpayers have no duty to point out items for which their treatment is questionable and help the IRS identify audit adjustments.

(2) The disclosures are generally limited to transactions that the IRS has identified as abusive tax avoidance, or transactions that have certain characteristics often associated with abusive tax shelters.

(a) Will that change with the new category of reportable transaction, the "transactions of interest"? Too early to tell, but it's an area of concern for many practitioners.

(3) Given the abuses in the past, the IRS reaction is understandable and inevitable. To the extent it changes tax advisor's relationships with their clients, it probably should.

ii) FIN 48 – tabular reconciliation of total unrecognized tax benefits as of the beginning and end of the period

(1) A disclosure of a significant balance, or significant change resulting from new positions, likely will have minimal, if any, effect in terms of increasing the likelihood that the taxpayer will be audited.

(a) Most of the companies subject to FIN 48 and with very significant balances or changes are probably subject to audit already.

(b) Other potential audit targets will be difficult to identify, even if the IRS devotes significant resources to reviewing public filings. Although the IRS could search a centralized repository of financial statements for such FIN 48 disclosures, such as SEC filings, some taxpayers are not subject to GAAP at all and others who issue GAAP reports may not be subject to SEC filing requirements.

(c) But if the taxpayer's disclosures are reported by the press, count on the IRS noticing.

(2) For a taxpayer already under examination, however, the FIN 48 disclosures may prompt the IRS to request the underlying tax accrual workpapers.

(a) In most cases, the IRS will identify the vulnerable tax position as part of its normal audit procedures.

(b) See above for the government position in *United States v. Textron Inc.* regarding the type of relevant information the IRS would seek in the tax accrual workpapers. Most if not all of that information will already be available or can be obtained without requesting the tax accrual workpapers.

(c) The implication is that the tax accrual workpapers may be requested because of the insights into the taxpayer's negotiating position with respect to the position. This will include not only some of the items, discussed above, that the government cited in *Textron* but also documentation prepared for the measurement analysis required as a result of FIN 48.

iii) FIN 48 – workpapers supporting the quantitative measurement of the tax benefit that can be recognized.

(1) "Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the **amounts and probabilities of the outcomes that could be realized upon ultimate settlement** . . . ." FIN 48 § 8 (emphasis added)

(2) In effect, the tax accrual workpapers disclose information about the taxpayer's negotiating position: what is the maximum amount the taxpayer might agree to concede?

(3) Forced disclosure of such information to the party with whom one is negotiating is virtually unprecedented.

iv) FIN 48 – disclosure of significant potential changes in the amount of unrecognized tax benefits in the coming 12 months.

(1) The IRS has already identified this as an item they will look at – see above for comments by Robert Adams.

(2) Changes could be due to factors such as resolution of a pending court case or the expiration of the statute of limitations.

(3) As with the tabular reconciliation, it is unclear whether the IRS will review this information unless the taxpayer is already under audit. Assuming that the tax position was not hidden through a mechanism like a grantor trust, the IRS probably is already aware of the transaction.

(4) What the IRS would obtain from this disclosure, either directly or by requesting the tax accrual workpapers, is:

(a) A reminder to review it again soon because, for example, the statute of limitations is about to expire.

(b) Management's analysis of why a substantial portion (perhaps all) of tax benefit was not recognized, that is, management's perceptions of the weaknesses and the resulting probable settlement outcomes. As with the FIN 48 measurement analysis, this discloses the taxpayer's negotiating position.

v) Not all information can (or need be) withheld from the IRS

(1) The reportable transaction disclosures and the FIN 48 public disclosures (the tabular reconciliation and the "12 month" disclosure) obviously cannot. The issue is only the underlying information in the tax accrual workpapers.

(2) Normally we withhold tax opinions as privileged, but often the tax opinion itself discloses nothing that we care about the IRS knowing. If the tax opinion itself is not harmful, we still withhold it in order to avoid a broad subject matter waiver of privilege, opening the door to all other communications with the tax advisor, including oral communications.

(3) The tax accrual workpapers, though, include some information that the taxpayer has a legitimate interest in withholding. Particularly with the promulgation of FIN 48, the taxpayer likely documents information concerning not only the facts and legal analysis concerning the transaction but also management's evaluation of potential weaknesses. This effectively discloses the taxpayer's negotiation position, and turns the taxpayer's ceiling (maximum concession acceptable) into the government's floor (minimum taxpayer concession demanded).

b) Can the taxpayer successfully withhold the tax accrual workpapers?

i) Omit the information concerning evaluation of potential weaknesses and likely settlement outcomes from the information shared with the outside auditor?

(1) The auditor will insist on such documentation. AICPA Statements on Auditing Standards 31, 80 – Evidential Matter; Auditing Interpretation (March 1981) – The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals.

(2) Sarbanes Oxley Act, Pub. L. 107-204, § 404 is increasing the pressure on management to assess the effectiveness of the internal control structure and procedures for financial reporting and on the outside auditor to report on that assessment.

ii) Hope that the IRS continues its policy of restraint?

(1) Don't count on it!

iii) The "two memo" approach.

(1) The tax advisor issues one memorandum to be shared with the independent auditor, which is not intended as a confidential communication, and another more detailed memorandum that is intended as confidential and is not shared with the outside auditor.

(2) Note: This approach must be used **very** carefully. Failure to fully inform the independent auditor may violate SEC rules. This exposes both the taxpayer and, potentially, the tax advisor to severe sanctions if the first memorandum omits relevant information.

(3) It is questionable whether this even works. The attorney-client privilege attaches to communications, intended to be confidential, from the client. Communications from the attorney are privileged only derivatively, because they disclose what the client told the attorney. Can the taxpayer argue that some of the communications to the attorney were intended to be confidential and some were not? Can the taxpayer argue that the memo shared with the outside auditors was prepared solely based on the communications in the first category?

(4) Even if this approach will work, some of the information the taxpayer legitimately wants to withhold would have to be included in the second memo. The taxpayer's assessment of potential weaknesses and acceptable settlement amounts is part of what the outside auditor will insist on seeing in order to validate the FIN 48 measurement analysis.

iv) Argue that disclosure to the outside auditor does not waive privilege (attorney-client privilege or Section 7525 tax practitioner privilege).

(1) *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984) upheld the IRS right to summons tax accrual workpapers prepared by the independent auditor.

(2) But this decision is potentially distinguishable.

(a) The *Arthur Young* Court noted that the IRS policy of restraint concerning requesting tax accrual workpapers "further refutes respondents' fairness argument and reflects an administrative flexibility that reinforces our decision not to reduce irrevocably the § 7602 summons power." To the extent that the IRS rethinks the policy of restraint, taxpayers could argue to distinguish, if not reconsider, *Arthur Young*.

(b) The Supreme Court has also noted that the summons power in Section 7602 is "subject to the traditional privileges and limitations." *United States v. Euge*, 444 U.S. 707, 714 (1980) (cited in *Arthur Young*). No such privileges were in play in *Arthur Young*, as the workpapers were not prepared by an attorney and the Section 7525 tax practitioner privilege had not yet been enacted. Arguably, if such privileges are applicable, they could protect tax accrual workpapers from disclosure.

(3) *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982) held that tax accrual workpapers were not privileged because they were disclosed to the outside auditors. In *United States v. Rockwell Int'l*, 897 F.2d 1255 (3d Cir. 1990), the court recognized this as a difficult question, citing *El Paso* and *United States v. Upjohn Co.*, 600 F.2d 1223 (6th Cir. 1979), *rev'd on other grounds*, 449 U.S. 383 (1981).

(4) Watch for the result in *Textron*!

v) Argue that the FIN 48 evaluation for particular tax positions constitutes core work product prepared in anticipation of litigation. (The recognition threshold is evaluated as if "the taxpayer takes the dispute to the court of last resort," ¶A2, and the measurement analysis considers the likelihood that the parties will "negotiate a settlement to avoid the costs and hazards of litigation," ¶A3.

(1) *Cf. United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006) (holding that a tax opinion prepared by KPMG qualified as work product and quashing the IRS summons).

(2) *But see Bernardo v.* Commissioner, 104 T.C. 677, 688-89 (1995), which the IRS sometimes argues limits claims of work-product to documents prepared after an actual controversy with the IRS arises. *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982) held that tax accrual workpapers were not work-product materials because they were not prepared in anticipation of litigation, using the "primary motivating purpose" test. As the court recognized, however, this is a factual determination and a "slippery task."

(3) At least some courts hold that work product protection is not waived by disclosure to independent auditors. *See supra* page 8.

(4) This may be the taxpayer's strongest argument.

vi) Ultimately, though, none of these approaches may prove successful.

6) Other considerations for tax advisors/planners resulting from the new age of transparency

   a) The possible settlement outcomes will have to be assessed at an earlier stage in the return/audit/appeal/litigation process.

      i) Now the taxpayer, if subject to FIN 48, must assess possible settlement outcomes when the tax position is included in a return. Absent FIN 48 requirements, the taxpayer could defer that assessment and perform it in stages:

         (1) Wait to see whether the IRS raises the issue on audit before deciding whether the possible settlement at Appeals warrants filing a protest.

         (2) Wait to see the results at Appeals before deciding whether the possibility of a better result warrants a Tax Court petition or tax refund suit.

   b) Will the taxpayer have enough experience to evaluate effectively the likelihood of various potential settlement outcomes? This goes beyond general legal expertise and the ability to analyze a legal question, to familiarity and experience with the Appeals and litigation processes. Many taxpayers will have the necessary expertise, but there will be some increased demand for evaluations from outside advisors of possible settlement outcomes

   c) Are such evaluations of possible settlement outcomes subject to Circular 230 requirements?

      i) The determination of whether a tax position meets the recognition threshold for FIN 48 does not take those factors into account. The measurement analysis for FIN 48, on the other hand, seems to permit, if not require, a consideration of settlement outcomes.

      ii) The tax advisor can provide an assessment of probable settlement outcomes without coming within the bounds of a "covered opinion." But the tax advisor is not to "take into account the possibility . . . that an issue will be resolved through settlement if raised" when evaluating a Federal tax issue in other written advice. § 10.37.

      iii) Caution is advised, in order to provide the client such an evaluation within the requirements of Circular 230.

STANDARDS OF PRACTICE FOR TAX ADVISORS/PLANNERS

1) ABA standards for lawyers

   a) Model Rules of Professional Conduct, e.g.

      i) Rule 2.1 Advisor

         (1) In representing a client, a lawyer shall exercise independent professional judgment and render candid advice.

         (2) A client is entitled to straightforward advice expressing the lawyer's honest assessment. A lawyer should not be deterred from giving candid advice by the prospect that the advice will be unpalatable to the client.

         (3) Advice couched in narrowly legal terms may be of little value to a client, especially where practical considerations, such as cost or effects on other people, are predominant. Purely technical legal advice, therefore, can sometimes be inadequate. Although a lawyer is not a moral advisor as such, moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied.

   b) Model Code of Professional Responsibility, e.g.

      i) Canon 7

         (1) A lawyer should represent a client zealously within the bounds of the law.

         (2) Where the bounds of law are uncertain, the action of a lawyer may depend on whether he is serving as advocate or adviser. A lawyer may serve simultaneously as both advocate and adviser, but he two roles are essentially different. In asserting a position on behalf of his client, an advocate for the most part deals with past conduct and must take the facts as he finds them. By contrast, a lawyer serving as adviser primarily assists his client in determining the course of future conduct and relationships.

         (3) A lawyer as adviser furthers the interest of his client by giving his professional opinion as to what he believes would likely be the ultimate decision of the courts on the matter at hand and by informing his client of the practical effect of such decision.

   c) ABA Opinion 314 (1965)

      i) Provisions with respect to tax shelter opinions and advising clients regarding return positions have since been superseded by ABA Opinion 346 and ABA Opinion 85-232 respectively.

ii) Standard for recommending that a position be taken on the taxpayer's return – "reasonable basis."

(1) The attorney owes "warm zeal" to the client.

(2) The IRS is not a tribunal or quasi-judicial institution to which the attorney owes a duty to disclose controlling authority.

(3) Allowed taxpayers to resolve questionable positions in their favor without disclosure.

iii) The "reasonable basis" standard may have been intended as a high standard when issued, but the standard eroded over time, accelerated by the tax shelter mania of the 1970's.

iv) Many practitioners understood the standard as supporting the use of any colorable claim on a tax return to justify exploitation of the audit lottery.

d) ABA Opinion 346 (1965) – tax shelter opinions

i) Not superseded by ABA Opinion 85-232.

ii) Differentiated between the lawyer as advocate or as advisor.

(1) In dealing with the IRS, the tax lawyer functioned as an advocate in an adversarial role.

(2) In rendering a tax shelter opinion to be relied on by third parties, the tax lawyer functioned as an advisor.

iii) Must consider all "material" tax issues – defined more narrowly than proposed amendments to Circular 230

iv) The lawyer had to opine on the likely outcome "if possible," but the Opinion recognized circumstances in which the lawyer was exempt from providing a conclusion.

e) ABA Opinion 85-232 (1985)

i) Restated the portion of Opinion 314 that dealt with a lawyer's duty in advising a client regarding return positions, but did not address tax controversy representation or negotiation and settlement proceedings before the IRS.

ii) Replaced the "reasonable basis" standard with a new standard of reporting. The practitioner must possess a good faith belief that the position is warranted in existing law (or can be supported by a good faith argument for an extension, modification or reversal of existing law) and there is some realistic possibility of success if the matter were litigated.

iii) The advisor also should refer to potential penalties and other legal consequences should the client take the position advised.

iv) Presumed an adversarial relationship with the IRS.

v) The ABA Section of Taxation had recommended a standard, based on a non-adversarial relationship with the IRS, that the position must be "meritorious" and "advanced in good faith, as evidenced by a practical and realistic possibility of success." The Ethics Committee rejected the Tax Section's proposal.

f) Proposed changes.

2) State bar standards for lawyers

a) Usually based on either the ABA Model Rules or the ABA Model Code.

b) For example, the Texas Disciplinary Rules of Professional Conduct are based on the ABA Model Rules.

c) Backed up by sanctions for failure to comply (e.g., Texas Rules of Disciplinary Procedure).

3) AICPA standards for CPA's

a) AICPA Code of Professional Conduct

b) AICPA Statements on Standards for Tax Services (2000), replacing the Statements on Responsibilities in Tax Practice, at http://tax.aicpa.org

i) Statement No. 1 – Tax Return Positions

(1) The CPA can recommend that the taxpayer take a tax return position if:

(a) The position has a realistic possibility of being sustained administratively or judicially on its merits if challenged; or

(b) The position is not frivolous and is appropriately disclosed.

(2) The CPA should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity to avoid penalties through disclosure.

(3) The CPA should not recommend a tax return position simply to play the "audit lottery" or to use the position in the bargaining process of settlement negotiations.

ii) Interpretation No. 1-1 – "Realistic Probability Standard"

(1) The CPA should have a good-faith belief that the position is warranted by existing law or can be supported by a good-faith argument for an extension, modification, or reversal of existing law through the administrative or judicial process.

(2) This evaluation should be based on reasonable interpretations of tax law and should not take into account the likelihood of audit or detection.

(3) The CPA may rely on authorities in addition to those relevant to determining whether substantial authority exists for purposes of I.R.C. § 6662 – for example, treatises, articles in recognized professional tax publications, and other sources commonly used by tax advisors.

iii) Interpretation No. 1-2 – "Tax Planning"

(1) Issued in 2003 due to concerns about tax shelters and abusive transactions.

(2) The CPA should, when issuing an opinion:

(a) Establish the relevant background facts.

(b) Consider the reasonableness of the assumptions and representations (consider the source and consistency with other information).

(c) Apply the pertinent authorities to the relevant facts.

(d) Consider the business purpose and economic substance of the transaction, if relevant to the tax consequences of the transaction (cannot assume that the transaction is entered into for valid business reasons without specifying what those reasons are).

(e) Arrive at a conclusion supported by the authorities.

(3) When evaluating an opinion prepared by a third party, the CPA should be satisfied as to the source, relevance, and persuasiveness of the opinion, which would include considering whether the opinion indicates the third party met those same standards.

4) Federal standards for all practitioners

a) Treasury Department Circular No. 230 (31 C.F.R. Subtitle A, Part 10), at http://www.irs.gov/pub/irs-pdf/pcir230.pdf

i) Section 10.34 – advising with respect to tax return positions, and preparing or signing returns

(1) Signing a tax return as preparer – the tax return positions must have a realistic possibility of being sustained on the merits (approximately 33% or greater likelihood of success), or must be non-frivolous and adequately disclosed.

(2) Advising a client to take a position or preparing a portion of the return on which the position is taken – the position must meet the realistic possibility standard, or it must be non-frivolous and the practitioner must advise the client of the opportunity to avoid penalties through adequate disclosure.

(3) The practitioner must inform the client of the penalties reasonably likely to apply to the client with respect to the position.

(4) The practitioner generally can rely, in good faith without verification, on information furnished by the client but cannot ignore implications of the information known and must make reasonable inquiries if the information appears to be incorrect, inconsistent, or incomplete.

ii) Section 10.35 – requirements for covered opinions

(1) Scope of "covered opinions" includes written advice concerning one or more Federal tax issues which are

(a) The same as or substantially to a listed transaction

(b) A transaction the principal purpose of which is the avoidance or evasion of tax

(c) A transaction for which a significant purpose is the avoidance or evasion of tax if it is:

(i) A reliance opinion – concludes at a confidence level of at least more likely than not that it will be resolved in the taxpayer's favor.

1. Can "legend out" of this category.

(ii) A marketed opinion – the practitioner knows or has reason to know that it will be used to promote, market or recommend a partnership or other entity, investment plan or arrangement to one or more taxpayers.

1. Can "legend out" of this category.

2. A practitioner ***must*** "legend out" if she cannot conclude at a more likely than not confidence level that the taxpayer will prevail on each significant Federal tax issue.

(iii) Subject to conditions of confidentiality, regardless of whether the limitation on disclosure is legally binding.

(iv) Subject to contractual protection.

(2) But written advice is not a "covered opinion" if

(a) The practitioner is reasonably expected to provide subsequent written advice to the client that will meet the covered opinion requirements.

(b) It involves a significant purpose transaction for which the written advice concerns the qualification of a qualified plan, is a state or local bond opinion, or is included in documents required to be filed with the SEC.

(c) It is provided after the tax return is filed, unless the practitioner knows or has reason to know that the written advice will be relied upon by the taxpayer to take a position on a subsequent tax return.

(d) It is provided in the practitioner's capacity as an employee to her employer.

(e) It does not reach a conclusion favorable to the taxpayer at ***any*** confidence level (e.g., non frivolous, realistic possibility of success, reasonable basis, substantial authority).

(f) It does not concern a "significant Federal tax issue," that is, the IRS would not have a reasonable basis for a successful challenge or the resolution of the issue would not have a significant impact on the overall tax treatment.

(3) Requirements for covered opinions

(a) Factual matters

(i) Must use reasonable efforts to identify and ascertain the facts, and identify and consider in the opinion all relevant facts.

(ii) Must not base the opinion on any unreasonable factual assumptions.

(iii) Must not base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person.

(b) The opinion must relate the applicable law to the relevant facts, without any unreasonable legal assumptions, representations, or conclusions, and must not contain internally inconsistent legal analyses or conclusions.

(c) The opinion must provide a conclusion with respect to each significant Federal tax issue considered, along with the facts and analysis supporting those conclusions. The evaluation must be based on the chances of success on the merits, and must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

(i) A "limited scope" opinions, addressing less than all of the significant Federal tax issues, is permitted if:

1. It does not involve a listed transaction or a primary purpose transaction, and is not a marketed opinion; and

2. The opinion prominently discloses the limitation and that the taxpayer cannot use the opinion to avoid penalties with respect to the issues outside the opinion's scope.

(d) If the practitioner relies on the opinion of another practitioner, the other opinion must be identified and its conclusions set forth.

(e) The opinion must prominently disclose the existence of certain relationships between the practitioner and anyone (other than the client) engaged in promoting, marketing or recommending the transaction that is the subject of the opinion.

iii) Section 10.37 – requirements for all written advice other than “covered opinions”

(1) The practitioner must not base the written advice on unreasonable factual or legal assumptions, or unreasonably rely on representations, statements, findings or agreements of the taxpayer or any other person.

(2) The practitioner must consider all relevant facts.

(3) The practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

b) Proposed changes..